INSIDE THE BOX

by Steve Brown

We often hear bankers say they don't have a rate view. These same bankers also say they try to manage their balance sheet to make money regardless of where rates go. This notion, that we call "managing in a box" (since all sides of the balance sheet are constrained), does not allow a bank to adjust to changing market or customer conditions.

One thing banks that outperform the average institution in most rate environments do is to have a rate view. It is imperative to superior performance.

By having a view, we don't mean to imply that a manager should "bet the bank" on a single rate expectation. Rather, top performing banks utilize a spectrum of paths. While the average bank usually keeps both liabilities and duration short (around 2Ys), top performing banks increase liability duration when rates reach low points and increase asset duration when rates reach high points. In short, they take advantage of the yield curve.

Many top performing banks these days know the FRB has been very accommodative with rates. In response, some have been selling off assets, taking gains and waiting for rates to rise. It is too soon to tell whether this will be a winning strategy, but intuitively it does make some sense. During recent history, top performing banks have margins that are about 1% better than average.

While banks can make money without having a rate view, they usually under-perform - unless they get lucky. Managing duration, pricing and growth are all a function of future rates. If you don't hold a rate view, then you take on the view of the market by default, since both asset and liability prices take future rate expectations into account.

It is not only important to have a rate view, but to act on it in concert with the rest of the bank. Currently, the market has priced in a 2.00% Fed Funds rate and a 4.07% (up from 3.85% today). If you agree that long-term rates will rise about 25bp, then the next question to ask is how to prepare for it?

For example, many bankers now are extending liability duration? By knowing brokered CD rates or FHLB advance levels, bankers can get a very accurate picture of where the market believes liability costs are going. These rates serve as an excellent benchmark. If liabilities in the branch can be gathered below these levels for comparable maturities in the local market, then this would present a positive opportunity. If not, then higher priced liabilities should at least be considered to be driven out.

If your rate view is different than that of the market, then so much the better, as now the bank can utilize both retail and wholesale funding channels.

While executing a rate view strategy is no guarantee of performance, it does offer the highest probability to garner additional spread, compared to a bank that never adjusts their balance sheet for rates.

No bank executes a rate view strategy perfectly for any consistent period of time. The goal is to get in the right ballpark, plan for contingencies and be able to track performance. Missing opportunities in the market place is true risk. By keeping the balance sheet in the box, bankers limit themselves to opportunities for expansion.

BANK NEWS

Home Equity Cuts

Washington Mutual will follow Bank of America, Countrywide, Wells Fargo, Wachovia and others by cutting $6B in home equity credit to customers. The thrift said it will cut lines regardless of borrower credit history if the underlying home price has depreciated. WAMU reported a 35% increase in nonperforming home equity loans in the 1Q compared to the same period last year.

Firing Staff

JPMorgan is expected to fire 4,000 employees worldwide, as it absorbs Bear Stearns and adjusts to a slowdown in investment banking activity.

In a Recession

The latest survey finds 77% of people now believe economic conditions are getting worse, the highest reading in 27Ys.

New Home Owners

A new study finds 60% of people say they won't buy a home in the next 2Ys, up from 53% who said so at the end of 2006. In addition, 67% think it is harder for first time buyers than it was 5Ys ago.

Loan Opportunity

Banks seeking loans should know studies show 14% of successful small businesses got a bank loan to start their company and 23% tapped a line of credit. While most will fund their venture from savings (79%), opportunities remain for the savvy community bank. Consider a program that lets your wealthier clients know their nieces, nephews and others they know can get a loan instead of lending directly to them to start a business (19% will borrow from a family member or close friend).