DRINKING FROM A FIRE HOSE

by Steve Brown

As exhausted bankers try to absorb what seems like a nonstop flow of regulatory communiques these days, sometimes it can feel like you are drinking from a fire hose. Since interest rate risk has surfaced once again as an issue (albeit one that is probably a few months off), we decided to take a moment to reacquaint everyone with some of the basic elements of interest rate risk. These elements include repricing, basis, yield curve and options risk. So, as you prepare to fight the fire of interest rate risk, here is a deeper discussion of each one.

Regulatory literature describes repricing risk as the result of timing differences between coupon changes or cash flows from assets, liabilities and off-balance sheet instruments. One example of this could be a long-term fixed rate loan that is funded by short-term deposits. When rates shift up, deposit funding costs will change more quickly than the yield on the loan. The result is that the loan value drops more than the value of the deposits, thereby affecting the value of capital.

Basis risk for community banks happens most often when coupon rates change for assets at a different speed than they do for liabilities. One example of this occurs when deposit rates (which are quite often highly correlated to Libor) shift by a greater amount than a loan based on another index such as Prime. While both rates are floating, recall that when rates rise (it has been a long time after all), the Prime rate is less sensitive to market movement and lags Libor in a rising rate environment (thereby creating basis risk).

Yield curve risk is another issue community bankers will have to account for as rates shift. Yield curve risk occurs because as interest rates change, they rarely do so in uniform pattern. Different cash flows are discounted at different relative rates, thereby impacting an instrument's value. A non-amortizing loan with a 5Y maturity may actually increase in value if short-term rates move up and intermediate rates move down in a yield curve flattening. Banks should be prepared to capture such flattening, "twists" and "smiles" of the curve.

Option risk is the 4th major risk community bankers should monitor when it comes to interest rate risk management. Option risk happens when an asset (or liability) experiences a shift in cashflow timing due to a decision made by the borrower (or lender). The most recognizable form of option risk is a loan prepayment, in response to market interest rate changes, which can significantly impact earnings. In these cases, asset yields can be reduced, funding costs can increase and the price or value of the underling asset/liability can be sharply reduced.

Remembering the basics of these 4 risks is important to ensuring your bank is well-managed. Remember that interest rate risk is nothing more than the potential changes in interest rates will reduce your earnings or economic value. As with the fire hose analogy, when too much interest rate risk flows through, bank capital and earnings can be hit hard. There is a lot to absorb when you start thinking about interest rate risk, so we'll cover this subject again as we continue to monitor fire conditions.

BANK NEWS

Affirmed

The Senate confirmed Ben Bernanke for a 2nd 4Y term as FRB Chairman by a vote of 70 to 30.

Small Business Stimulus

The Administration is set to release details in a couple hours regarding the new $33B small business stimulus tax credit program.

AIG

The beleaguered company borrowed $2.4B on its Fed credit line, the most since the start of the line in Oct.

Value vs. Free

With overdraft fee revenue under regulatory pressure, banks are turning to providing value for a small fee. Fifth Third attributes nearly 1 in 5 checking accounts opened its Secure Account Checking, which brings in $7.50 a month for identity-theft monitoring. Meanwhile, BBVA Compass notes 80% of new accounts it opens are "premium checking accounts" which include monthly fee generating options like out-of network ATM use.

Industry Perspective

Bank of America's new CEO, Brian Moynihan said he expects a "long, slow economic recovery." Meanwhile, Credit Suisse expects the banking sector will face pressure on revenues this year, continued high credit costs, shrinking loan balances and reduced fee income. The good news, Credit Suisse also expects provisions to fall in 2010 as delinquency and loss trends become more positive.

Construction

The Associated General Contractors reports areas hit hardest by loss of construction jobs in order for 2009 were Phoenix (-28,900), Houston (-25,800), Atlanta (-23,000), Chicago (-24,900) and Las Vegas (-20,300).

Mobile MOney

Within the next several months, consumers will be able to send cash to and from bank accounts with their cell phones. Currently, one can only send money by mobile phone though prepaid cards and transfer services like PayPal.

Really Rich

Analysis finds there are 751k affluent families worth $20mm or more that control approximately $96.8T in financial assets.