A POSSIBLE UNKIND CUT

by Steve Brown

An analyst ran into our office this morning babbling something about being wary of the Ides of March and how Julius Caesar and Tim Geithner look alike. We don't need anything more to worry about, because our goal today is to get our NCAA bracket done, but this soothsayer happens to be a crack analyst so we were all ears. As this analyst also pointed out, while there are risks to a bank's balance sheet from a quick upward shift in rates, the real risk is the unprecedented amount of basis risk that banks are carrying and the impact if we simply go along the forward curve.

This basis risk is a result of two factors. One, Libor is low, sensitive and ready to move up quickly. On the other hand, the Fed may lack desire to move the target Fed Funds rate up quickly, due to the fear of putting too much pressure on the economy. When the target Fed Funds rate does move, existing floors on loans will also hurt margins.

Remember, that the average bank's cost of funding is very closely correlated to LIBOR (true for the majority of banks in the country). On the other hand, 98% of the average community bank's floating rate loans are tied to Prime. Most bankers pay little attention to the mismatch. However, with LIBOR repricing daily and Prime repricing an average of 8x per year, a steep and low yield curve results in staggering basis risk. For example, a $120mm Prime-based loan portfolio is expected to net a bank $16.4mm less yield than the same gross yielding LIBOR-based portfolio (we have the math if anyone would like to see it).

The story gets worse when you also throw in that banks are not nearly as asset sensitive as they believe they are. The reason is that assets extend and liabilities shorten when rates move up. That is the natural price that banks pay for being short convexity. Banks charge neither enough for prepayment on CDs when rates rise, nor enough for prepayment on loans when rates fall. The result is that both sides of the balance sheet extend or shorten just at the most inopportune time. This situation is further exacerbated, due to rates being kept low for so long and the media coverage that rates will get when Libor starts to climb. This convexity adjustment is currently worth approximately 40bps of spread income for the some community banks.

What can banks do to keep from getting stabbed in the back? For starters, banks should expect MMDA/Savings/NOW deposit categories to shrink faster than average, in terms of volume and duration, as rates rise (thereby, increasing deposit sensitivity). As rates rise, depositor sensitivity to investment returns increases and deposit maturity decreases (thereby resulting in an exacerbated duration gap).

Our analysis shows that for the average community bank in this country, assuming no change in asset and liability mix (or sensitivity) and no change in credit quality, NIM will contract 45bps over the next 8 quarters - simply from rising interest rates. This view is based on rate movement reflected in the forward curve using call report data. If the forward curve is incorrect and rates move 100bps higher than projected, then the average bank's NIM contraction will be 75bps in 8 quarters. A 200bps parallel shift will squeeze NIM by 95bps in 8 quarters.

Just as Caesar didn't heed the soothsayers words, we don't expect you to take our word for it. We developed a simplified model that applies current average decay rates and interest sensitivities to banks, based on their historic correlations to interest rates. We then project NIM going forward, based on the forward curve. This gives us a ballpark idea as to how sensitive a bank is in this current environment. If you are in the C-suite and would like a quick (and free) look at your bank, we can demonstrate effective sensitivity and discuss possible solutions. Contact us to schedule a 30-minute online review just for your bank, so that we can help prevent interest rates playing the part of Brutus when the economy improves.

BANK NEWS

Banks Closed (30 YTD)

The FDIC closed on Friday: 1) Park Avenue Bank ($520mm, NY). Valley National Bank ($14.3B, NJ) will purchase all deposits for a 0.15% premium and nearly all assets with $380mm under a loss share. 2) Old Southern Bank ($316mm, FL) with Centennial Bank ($2.8B, AR) acquiring all deposits for a 1% premium and essentially all assets with $283mm in a loss share. 3) Statewide Bank ($243mm, LA). Home Bank ($501mm, LA) will assume all deposits for no premium and all assets with $164mm under a loss share. For more details, go here at BIG Metrics.

M&A

First National Bank of Hutchinson ($523mm, KS) will merge with BankHaven ($23mm, KS).

Protracted Protection

The FDIC voted to extend its safe harbor for securitized assets from 3/31/10 to 9/30/10.

Mortgages

Foreclosures dropped 2% in Feb, though were still up 6% from 2009.

Long Term

The President of FRB Chicago noted in a speech that an unemployment rate of 4.75%, previously seen as a market with full employment, may have to be pushed to about 5.25%, with this likely to "be appropriate for some time."