FISH AND CHIPS

by Steve Brown

Walk around the UK as a traveler and you will find plenty of pubs offering "fish and chips" for lunch. We aren't quite sure why the meal is called "fish and chips" instead of "fish and fries," except to say it probably surfaced due to a centuries-old love-hate relationship between the British and the French. We can't imagine any self-respecting Brit wanting their beloved "chips" to get confused in any way with those fried potatoes carrying that other moniker.

Just as the British may not want to recognize the French, so too; US community banks may not want to recognize the British for inventing the London Interbank Offered Rate or "LIBOR." To understand why LIBOR even matters (as you think about where to buy your fish and fries/chips today for lunch), we first need to know what LIBOR is - simply a daily reference rate where one bank will lend to another bank in the London wholesale market.

LIBOR is used for many things including setting interest rates on loans (from fixed to floating), deposit rates and as a reference rate for currencies worldwide. So many global banks use LIBOR as a reference rate in fact, that it has become the de-facto method for pricing the world's most liquid markets. Maturities for LIBOR can be found stretching out as far as 50Ys, but most activity occurs with a maturity of 10Ys or less.

Looking at history, LIBOR caught fire primarily because bankers worldwide needed a common index they could use to transact business 24 hours, 7 days a week. Gone were the days when large US banks could work from 9am to 5pm, a global trading book emerged at large banks that was passed through multiple trading desks worldwide, on a relentless 24 hour schedule. Starting in New York, traders would work their 9am to 5pm shift. At its conclusion, they would then transfer their existing positions to the next shift, which given the time zone was Asia. The team in Asia would then work their own 9am to 5pm local shift, before passing the trading book along to their counterparts in London. Those traders would then repeat the cycle, before eventually handing the trading book back to their counterparts in New York. This structure is how large global banks trade billions of dollars of securities, currencies, cash, interest rates, loans and much more all day, every day (and night). It is also why LIBOR overwhelmed all other indices across the world.

For community banks, there is no global book of business to contend with, so Prime seems to work just fine. That is largely true; however an unstated (and perhaps unknown) undercurrent surfaces because community banks must compete in local markets against large global banks for deposits. Given that large global banks set their daily deposit rates based on LIBOR, and since they also control most of the deposits in any given US market in percentage terms; community banks are defacto setting their own deposit rates based on LIBOR. This may not be overtly understood or even tracked, but it is factual nonetheless.

Now that it is understood LIBOR is the baseline for bank deposits, it is easy to see why large banks doing business here favor LIBOR on the asset side as well. To avoid mismatching funding costs and lending indices, large banks use LIBOR on both sides of the equation.

While community bankers don't have to worry as much as the Brits about whether or not they like chips or fries, it is important to know that LIBOR is the underlying basis for how deposit rates are set all over the world (and a proxy for baseline funding costs of large banks). Once we know LIBOR is the basis for funding, it is easier to understand why large banks price loans at a spread over LIBOR. To keep tabs on where Libor is every morning, the grid below captures a snapshot for you from 1M to 1Y (Libor Rates) and then from 2Y to 15Y in the next column over (3ML Swap). If you need something more current, or are adding in structure of any sort, give us a call and we would be happy to help you calculate your margin and your risk-adjusted return. Until then, "Pip pip, cheerio and all that rot."

BANK NEWS

Deposit Insurance

The senate voted unanimously in support of calculating deposit insurance based on risk vs. deposits, a plus for community banks. A similar measure is already in the reform bill passed by the House.

Liquidity

After yesterday, the price of liquidity has increased. The BOJ and ECB will both open/expand facilities to provide greater liquidity to their respective banks.

Branch M&A

AnchorBank ($4.5B, WI) will sell 4 branches to Nicolet National Bank ($657mm, WI) for an undisclosed sum. Nicolet will acquire $116mm in deposits in addition to real estate and loans. This also follows an 11 branch sale by AnchorBank to Royal Credit Union.