CALL OPTIONS IN DEPOSITS

by Steve Brown

In CA, it is a forgone conclusion that every day you will be stuck driving behind a person that refuses to let such trivial skills like steering and braking interfere with using a cell phone. The other day, we witnessed an accident where a guy rear-ended the car in front, but did not get out of his car until he finished a text message he was working on. At 55mph, a short text or call takes a driver's eyes off the road for 5 seconds - enough to cover a football field of distance. This makes a driver who is texting 23x more likely to get into an accident. We have people here that won't eat red meat for fear of cancer, but that same crowd thinks nothing of dramatically shortening their expected life by letting their spouse know that they are on the way home via text.

In much the same way using a cell phone while driving can shorten the expected life of a driver, a call option shortens the expected life of a liability. A call feature in your liabilities makes you long the option. Being long the option allows the bank to cancel issued liabilities and helps with interest rate risk management. Retaining an option has proven particularly helpful in this market for managing both funding and interest rate risk.

A bank may have a group of assets, such as loans or callable securities, which can prepay. As bankers have experienced first-hand, these assets prepay when rates drop and reinvestment choices are poor. Conversely, these assets extend when rates rise (when you actually would like your cash flow back). This characteristic is called "negative convexity" and it can hurt bank performance. Negative convexity is something banks should avoid whenever possible, unless they are being properly compensated. Unfortunately, most banks are not being properly compensated right now, which makes this important to manage.

Right now, there is a rarity in the marketplace - liquidity is plentiful and buyers are just looking for the highest coupon possible regardless of optionality. Since these buyers don't place the proper value on an option, banks that take advantage of this structure can garner better performance.

For example, we can place brokered money (you can do this in your local market if you would like as well), with a 5Y maturity, that is callable monthly after 1Y at a 2.56% all-in cost to a bank. The coupon on these CDs increase each year (starting at 1.75%), going along the forward curve. Should rates rise slower than expected (as has occurred for the past year) or the issuing bank doesn't need the funding (has also occurred), the bank simply calls the issue back. If rates rise faster than expected and the CDs stay to maturity, the issuing bank has paid a total cost of 2.56%. This compares to a 2.50% issuance cost to the bank that issues a bullet CD right now of similar maturity. While the callable structure costs a little more, it provides flexibility to both funding and interest rate risk. The value of that option (you could theoretically sell it separately) equates to about 16bp of value per year. In other words, while a bank pays an additional 6bp for the option, it is really worth 16bp mathematically, for a net gain of 10bp. Another way to look at this is the positive convexity on this deposit is an impressive 0.68. To put this in perspective, if you hold residential mortgages in your loan portfolio, these assets have an average convexity of -0.78 (down from -1.15 in 2007). Thus, if you used this funding method to support SFR mortgage holdings, the bank would only have a deminimus -0.10 of convexity to manage.

If you own loans, securities or other assets with optionality (the ability for the borrower to prepay), contact us to take advantage of this opportunity. Record low rates and this mispricing of optionality makes this an excellent time for banks to cheaply lay off interest rate and funding risk. In the meantime, watch out for drivers typing "lol im nt bsy im only driving" on their cell phones.

BANK NEWS

M&A

Community Trust Bancorp ($3.2Bm, KY) has entered a deal to acquire LaFollette First National Corporation ($184mm, TN) for an estimated $16.1mm.

Ag Banks

In the 1Q, only 7.28% of banks holding more than 25% of their portfolio in Ag loans experienced net losses, compared to the overall average of 18.67%. Despite these numbers, one should still examine the details and with focus on diversity. Crop farming overall fared better than livestock, and dairy saw some trouble in 2008 and 2009.

Text Alert

Chase will now send out a text message to customers when account balances drop below a user set minimum. The user may then initiate a funds transfer by replying "Transfer $100 from savings account."

Homeowners

The US rate of homeownership dropped to 67% from a high of 69% in 2009. Accounting for homes currently underwater and unlikely to recover equity, FRB NY notes that levels could drop to the mid-90's levels of around 62% in the next several years.

Overdraft

According to an ACTON Market Intelligence study, nearly 4 in 10 customers will opt in for overdraft protection. Of customers that overdraw more than 10X per year, more than 75 intend to opt in for overdraft protection. For those less than 10X per year, over 50% will opt in, and those that do not overdraw, only 30% will opt in.