BEWARE OF BIRD BLOBS WHEN MANAGING RISK

by Steve Brown

Sometime in your life it is inevitable that a bird will poop on your head. Let's hope you are not heading into some important meeting, because when that occurs, it can be quite disconcerting, embarrassing and even throw you off your game. The good news is that we have also heard it said that when a bird poops on your head it is considered good luck. We don't know whether that is because the odds are so astronomical, the chances are about the same as winning the lottery. Or, perhaps it is because the only thing you get out of something so disgusting is a weird white blotch in your hair which somehow is magical enough to deliver good luck. We cannot be certain of either, but when this eventually happens to you, it certainly feels better at the very least to think about the good luck you are about to get, rather than the fact you just got pooped on. In banking, being careful where you walk is important if you want to avoid issues.

One place to begin is with a bit of perspective. In case you haven't looked lately, the yield curve is about 50bp above zero at the 2Y point, 150bp at the 5Y point and only 280bp at the 10Y point. As a country, industry and about any other way you want to measure things, we have never been here before, so the future remains uncertain. One thing we feel fairly certain about, however, is that rates are unlikely to go negative and the next move is probably higher, albeit at probably an excruciatingly long, slow and painful pace.

This issue is one reason why regulators are urging bankers to stress test to see what happens to your bank when rates rise 300bp, 400bp and even as much as 600bp. While that sounds like a lot at face value, with Fed Funds at 0bp to 25bp, an up 400bp shock still only puts Fed Funds at 4.00% to 4.25%. That represents an economy that is not growing at gangbuster levels, but instead is moving along at a moderate recovery clip. When you think about things that way, it is easy to see why regulators are nervous and are urging bankers to ramp up the testing to get ahead of such an event. While it could take as long as 5Ys for that to happen if you believe some economists, it could be as short as 2Ys according to others. Since no one truly knows, testing now to avoid unintended blobs makes sense.

Another critically important aspect of all of this relates to the loan portfolio. While rising rates could be a positive for some banks, it will end up hurting others. Consider banks that have a group of loans on the books with floors. If the Fed raises rates say 250bp and then stops, funding costs would rise, while the loan revenue may not due to the floors not being disengaged. Given how low rates are now, many expect the Fed to ratchet things up pretty fast once they get going, but this may not be the case. Again, we have never been here before, so understanding the impact on your bank if the process is slower than expected can give you enough time to mitigate the issue. This is an important piece to any stress testing process.

Finally, banks need to keep in mind the impact of rising rates on credit. Consider a floating rate loan that is cash-flowing nicely today at 1.50x debt service coverage. If rates increase 150bp on a 5Y loan, debt service requirements almost double because absolute current levels are so low. Can the cashflow carry the debt load or does coverage turn negative? If the 5Y rate rises to 3% is that really a robust economy? Can the customer handle double the monthly interest payment or is this going to be the next potential wave of defaults? All of these issues are best identified through stress testing and cleaning up data on core systems to be sure you can easily capture it for modeling. Starting now, identifying where the biggest risks may be and taking action to mitigate issues before they happen; will help you avoid the dreaded blobs that at times rain down on the industry.

BANK NEWS

Cyber Monday

According to Coremetrics, Cyber Monday was the biggest shopping day of the year and posted sales 19.4% above last year.

Bank Wikileaks

The founder of Wikileaks, Julian Assange, continues to gather enemies faster than anyone on the planet. Assange revealed that after the first of the year, he will release internal documents from a major US bank that will find itself "turned inside out." While the details aren't known, it is rumored that he will post e-mails that highlight the lack of oversight, self-dealing and unethical practices of executives.

OCC/OTS

The OCC and OTS will be holding a series of informal meetings to brief financial institutions on what the new combined regulatory agency will look and act like. Meetings are scheduled in 17 key cities between Jan and Mar. If you are interested in the dates, let us know.

Homes Back Stock

In Oct, foreclosure inventory rose by 263k homes, to a record high of 3.92% or 2.1mm loans. Worse yet, an additional 2.2mm loans are 90 days or more past due.

Housing

It is interesting to note that as of the end of 2009, Habitat for Humanity was the 8th largest home builder.