THEY SAY WE MIGHT HAVE A PROBLEM

by Steve Brown

Who are "they?" You often hear people bring "they" into the conversation when seeking to drop some wisdom on you. It begins with something as simple as "well, you know what they say don't you" or "they say it might rain today." We wonder why "they" just can't mind their own business. Well, if you find yourself face to face with someone "they-dropping," just for entertainment, try flinching every time that person uses "they" as a reference. If you do, at least you will entertain yourself. We received quite a few emails and calls from Tuesday's topic, so we continue our discussion with an additional twist to add clarity. We do so by focusing in on the next rate moves by the Fed, which will give some community banks a front row seat to the negative effects of managing rate risk by traditional methods.

Historically, community banks have largely managed interest rate risk by transferring it to their borrowers through an adjustable rate vehicle such as a Prime or other floating rate loan. In similar fashion, bankers have been content to manage both rate and liquidity risk, by pushing borrowers into short-term financing and then matching that up with loans that will have their rates reset within a period generally ranging from 1 to 5 years. While these methods have proven useful in the past, we are in a rate environment where rates could move up violently. Community banks today are exposed to an elevated level of credit risk when rates rise and that has the potential to have a materially negative impact on capital.

This increased level of credit risk arises due to two main factors. First, as rates fell dramatically debt coverage ratios (DCR) from borrowers did not widen out, due to the severity and aggressive nature of the economic downturn. The second contributor, related to the first, is the simple fact that as rates increase, the percentage increase in debt service will accelerate at a rate that is twice that of what we have seen in past cycles. Unlike past rate and credit cycles, this one may leave banks with borrowers who have substantially higher debt service requirements (due to rising rates), while the economy remains extremely weak.

The chart above shows the impact of rising rates on DCR based on four amortization/maturity structures for a Prime based loan (without embedded floors or ceilings), with an initial DCR (pre-stress) of 1.25. As can be seen, interest only structures are more sensitive than fully amortizing loans and suffer when rates rise. Meanwhile, structures where amortization occurs also see impacted credit quality, but while material, the impact is not as pronounced. Finally, non-amortizing structures see the percentage of DCR diminished as well. The decline is pronounced in all but a very short amortization/balloon structure.

Currently interest rate risk and credit risk are directly and inversely linked given today's interest rates. Rate risk tools such as adjustable rate loans, while effective in managing interest rate risk, will only serve to increase credit risk/loss until we return to a more normal rate environment (short rates up by 300bp).

Additionally in up 300bp scenarios, credit quality is so diminished that additional provisioning and/or charges-offs are likely as DCR ratios approach or fall below 1.00.

They never said banking was going to be easy, but stress testing your portfolio to fully understand the risks inherent in it is a good starting point. Once you have the information, you can then take steps to protect yourself and your borrowers.

BANK NEWS

Fed Liquidity

After the Fed released information about bank borrowings from its liquidity facilities you get the sense that the Fed is basically the central bank for the World. Barclays and UBS were heavy users of the $3.3T emergency facilities. That's said, there are several US banks that look like they were just arbitraging the US, which was in part, the point of the liquidity. While many community banks utilized the Term Auction Facility, we expected to see more.

Foreclosure Prices

Homes in the foreclosure process for 3Q sold for about 32% less than non-distressed properties, the biggest discount in 5Ys according to RealtyTrac. To put this in perspective, last year the discount for bank-owned residences was 29%.

OD Settlement

5th 3rd Bank agreed to pay $10mm to settle an overdraft related class action lawsuit which stemmed from the bank clearing the largest items first. The Bank now clears items as they come in.

Munis

We received lots of comments about the risk of the latest Nat'l Commission on Fiscal Responsibility proposal that has the tax exemption for munis going away. Our take - the proposal isn't retroactive so existing purchases are safe and it will never pass anyway.