FOLLOWING THE CROWD FOR LOAN AND RISK SUCCESS

by Steve Brown

Recent literature in neuroeconomics sheds light on behavior of financial professionals. It is no surprise that many recent findings show that humans are hyper-social and love to follow the crowd. While the results of following crowds are sometimes riots, overly popular restaurants, asset bubbles and Justin Beiber, they can also be used for a source of good - namely risk management.

While the evidence shows that for the last five quarters many banks have been increasing the duration of their assets, and the market has been shortening the duration of bank liabilities, smart banks are working hard to manage the interest rate risk. Better structuring of DDA accounts, shorter investment durations and fixed rate hedging are all activities that have become hyper-popular in the last year for banks.

On one side of the balance sheet, smart banks know that they shouldn't be using the same duration assumptions for their non-maturity deposits as they did 3Ys ago. As the premium on safety abates and rates start to come up off their 45 year lows, banks are finding that non-maturity accounts are about 70% of the duration of what they were in 2009. Consider that many banks that are on top of their ALM modeling are already making the assumption that some of the larger banks will be promoting interest on business checking in 3Q thereby shortening the duration on that product. Even stated maturity accounts such as CDs are now coming in shorter than historical average because of the high likelihood that a material amount of the population (an estimated 13%) will redeem their CDs and pay the limited penalties in order to garner a higher rate of return.

On the loan side, smart banks are also aware of the recent extension of loan maturities and as such, they have been unwilling to accommodate longer fixed rate loans. In the last several months, many loans that were slated to prepay early are not expecting to repay at maturity.

All this adds up to better future margins if your bank is prepared. Consider that the market expects (rightly or wrongly) bank's cost of funding to increase by approximately 4.20% over the next 5 years. This is really the basis for the regulators' insistence that banks stress performance and values for 400bps increase in rates. The market also expects bank's cost of funding to increase by approximately 5.25% over the next 10 years. We can debate if the markets expectation is realistic, but the debate only underscores the risk inherent in the expectation and does not diminish the risk. The market may be underestimating or overestimating future bank's cost of funding. The question for bankers is how to protect net interest margin.

Along with managing liabilities, many banks are turning to loan hedging solutions. One product we have designed is our Bankers Loan Processing (BLP) Program. BLP allows community banks to offer fixed rate loans to borrowers and enjoy the benefit of a floating rate asset. BLP works without ISDA documentation, without a derivative to the bank and without a swap to the borrower. We will be hosting two webinars outlining current interest rate risk in a rising interest rate environment and how BLP offers one solution to such risks. For bankers that want to learn more about BLP, please follow one of the links below to sign up for a webinar. There is no charge for participating and the webinar will last approximately 30-minutes followed by a Q&A period. The webinars will be March 8th (9am PT, 12pm ET):

https://bigevents.webex.com/bigevents/onstage/g.php?d=801101896&t=a and March 18th (11am PT, 2pm ET):

https://bigevents.webex.com/bigevents/onstage/g.php?d=800182527&t=a

While following the crowd can lead you into trouble, it can also lead you to superior performance. The BLP program has proven successful for hundreds of our client banks for 5Ys despite many ALM changes. It may pay for you to hear first hand the success of many of these banks that are forward looking in their management of interest rate risk. Besides following this crowd is a whole lot easier than listening to The Beibs.

BANK NEWS

Closure (23)

Valley Community Bank ($128mm, IL) was shuttered with First State Bank ($611mm, IL) assuming all of the deposits (no premium) and essentially all of the assets.

Moody's Defaults

Mark Zandi, the lead muni analyst at Moody's says the risk of a major default or a round of defaults in the muni market is "close to zero."

Elder Abuse

FINCEN issued an advisory regarding what banks can watch for to help prevent the financial exploitation of the elderly.

Berkshire

The Company's annual report is out along with Warren Buffet's famous annual Chairman's letter. This year, the missive talks about not putting excess cash flow (above what is needed for capital) back into the same industry because of the correlative risk (similar to banks reinvesting in finance companies). In addition, the letter hints that Berkshire is looking around for another "elephant" to purchase. For more insight, go: http://tiny.cc/BIG_Berkshire