

BEING ABLE TO LOOK AHEAD

by [Steve Brown](#)

Considering the fact that as a company, we see about 4k banks per year, thus we are well aware of the quality of drivers in most states. Please don't send us hate emails, because we know bad driving is a source of state pride, but here in CA, drivers are reckless. We invented the CA rolling stop which basically means a stop sign has the legal significance of an overgrown lawn. Yesterday we were passed on the freeway by a man that thought it was prudent to watch a video on his iPad while driving. While we are all for multitasking, we distinctly remember a driver's test question about keeping your eyes on the road just in case the need arises to do little things like steer or brake.

It is important to see where you are going, which brings us to today's topic of what is ahead for banks given the state of the markets. The obvious change over the last couple of weeks has been the extreme flattening of the yield curve. What was more than 300bp (2Y Treasury to 10Y Treasury) just a month ago, is now down to only 200bp. This flattening means that the future path of rates is lower, which judging by the futures markets, equates to a low and flat interest rate environment for the next 18+ months. Volatility has also spiked, which combined with low rates, means the monetization of more negative convexity. In other words, banks should prepare for even more cash flow to come in at a time when you least want it. Finally, the distribution of credit spreads has dramatically increased, which means you have to be very careful in allocating risk and the loans you make. This combination of trends sets the stage for a dismal 2012. Back in 2010, we projected a 6% ROE average for banks in 2011(looks like it will be closer to 5%). Now, we are predicting a 4% ROE for 2012, with most gains coming from lower provisions.

To beat the average, banks need to make several tactical moves that may not be obvious. First, banks need to quickly move away from focusing on net interest margin. Because of the dispersion of credit risk, banks that require a 300bp+ margin will find themselves adversely selected as to relationship quality. The best loans and deposits will go to banks that understand that a high quality relationship at a 220bp loan spread is usually better than a low quality relationship at a 350bp spread. Even if you can find and quantify a quality relationship at a 300bp NIM, supply is limited. For profitability, risk being equal, you would rather have 30 new relationships next year at a 200bp spread, than 10 at 300bp.

Another major move that banks have to make is to expend resources to protect good customers. While most banks are accustomed to looking at maturing loans 3 months out - that is not enough. To be competitive, you need to look 12 months forward and strategically refinance good customers into lower rates and lower margined loans in exchange for greater prepayment protection, longer duration and higher cross-sell. Even if profitability drops, it is far better to have a good customer go from a 40% ROE to a 20% ROE than to lose them entirely. Large banks are looking 6 months forward, so community banks must have a plan that looks further into the future.

At our upcoming Tactical Workshops in Richmond and Charlotte next month, we will be focusing on more of these tactics. If you can't attend, the key for producing a 12%+ ROE next year is to focus on attaining and retaining customers that are profitable on a risk-adjusted basis. To help you, we have products such as BIGProfit, BLP, Liability Coach, ALM and Credit Stress to mitigate much of the risk of what is presently occurring in the marketplace today. These products allow you to better see the road

ahead, which is much safer than looking at an iPad while driving. However, if you are reading this in your car, maybe you should move to CA in order to feel more at home.

BANK NEWS

Bank Closed (65 YTD)

In an unusual move, regulators closed Public Savings Bank (\$47mm, PA) on Thursday and sold it to Capital Bank (MD). Capital acquires 1 branch, assumes all deposits excluding brokered and essentially all of the assets. Public was closed on a Thursday because it serves the Jewish Orthodox community and regulators wanted to avoid conflicting with the Jewish Sabbath.

Competition

In an effort to strengthen customer relationships and increase customer spending, Citibank announced a smartphone app that lets customers redeem Citi rewards points for purchases at Best Buy. Customers can use points to buy products, but Citi indicates future capabilities may allow customers to redeem a portion of their points for a product and pay the remainder with a credit card.

Banking Job Cuts

Bank of America said it will cut 3,500 job cuts this quarter, following 2,500 already done earlier this year. Total cuts in investment banking and trading are expected to be 3% to 5% of its employees. Meanwhile, data compiled by Bloomberg finds the 50 largest global banks have announced almost 60k in job cuts through the first week of August, the fastest rate since 2008.

Less Paper

An internal US Bank study reportedly projects a 60% reduction of paper items from commercial, municipal and non-profit customers over the next 3Ys.

ID Protection

Regions Bank has created a suite of "Protection Services" composed of ID theft protection (\$2,500 of coverage), Triple Bureau Alert (monitoring) and Card Patrol (credit transaction and fraud alerts). The Bank charges \$5 per month for the add-on service and has rolled it out as a way to extend customer duration and generate fee income.

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