DE-COSTUMING YOUR LIABILITIES

by Steve Brown

Halloween is right around the corner and it is time to start thinking of a costume. Growing up, the default Halloween move was to throw on some fake blood and put in those plastic glow-in-the-dark vampire teeth. The problem with the teeth was that they invoked a strong gag reflex and caused you to drool all over yourself. Instead of some cool Twilight-like Prince of Darkness, homeowners would find some pathetic, retching kid with saliva running off his chin on their doorstep.

Just like some costumes that don't work out, banks are starting to have the same problem with liabilities as it is getting harder to see what is going on with core deposits. So far, we have looked through about 1,700 3Q call reports (those that were filed before this weekend's deadline) and noticed a couple of things. One, all the general feelings about the quarter are true. Loan growth is non-existent, earnings are up due to lower loan loss provisions / higher credit quality and ROE is on the rise. The other item that pops out is the structure of core liabilities.

As rates stay low for a long period of time and the industry is awash in liquidity, banks are reducing their CD rates, which is serving to drive more money into non-interest DDA accounts (core accounts are up about an annualized 8%). Cost of funds are coming down and without the pressure from loan growth, wholesale funds are still getting repaid at a rapid clip. The net result is a tighter distribution of banks that exhibit a low cost of funds and high level of core deposits.

While this is a good thing overall, what has occurred is the masquerading of accounts that exhibit a high degree of interest sensitivity into deposit accounts that are counted with having a much lower degree of sensitivity. It is assumed that these accounts are still interest rate sensitive, but are now "parked" waiting for a better opportunity.

The effects of this shifting of deposit account levels create several issues that bankers should be aware of. One, equity investors now spend more time questioning the value of the core deposits often now putting a greater discount on banks with new high core deposits levels. However, as time goes on, this will become harder and harder to do. Banks with strong deposit bases that are looking to sell themselves or looking to raise money have to find other ways to distinguish themselves on the liability side. Maybe this is providing more granularity of volume in account type (like money garnered in a goal oriented account) or maybe it is providing investors or potential investors on how your accounts have historically performed in a rising rate environment. Whatever you do, our point is an extra effort is now needed to distinguish banks that truly have a less interest rate sensitive deposit base.

This other aspect of this trend is when it comes to asset-liability management. As more money flows into non-interest maturity accounts, banks normally attribute these non-interest accounts with longer durations. If the value or duration is not shortening as these CD customers park their funds in core deposits, then there is a risk that banks are overestimating the value of these accounts. This might lead to the belief that a higher level of fixed rate loans or investments can be placed on the balance sheet that should be considered safe.

Of course the solution to both problems is to keep moving accounts into longer duration liability account types such as those that are service-oriented or those that have greater minimum balances. Greater cross-selling so more of your accounts use bill pay, remote deposit capture, an accounts receivable application or other cash management feature will help turn (and prove) that these once CD balances are being "de-sensitized."

If you are looking for a costume, you might consider an Occupy Wall Street protestor complete with sign and tear gas canister. If you are looking to take the costume off your liabilities, consider devoting a few resources to building and documenting a less interest rate sensitive deposit structure while rates are low.

BANK NEWS

Reserve Indexing

The Fed announced the indexing of 1st tier reserve level and exemption limit for 2012 that is used to calculate reserve requirements. For net transaction accounts in 2012, the first $11.5mm (up from $10.7mm), will be exempt from reserve requirements. A 3% reserve ratio will be assessed on transaction accounts of between $11.5mm to $71mm. A 10% reserve ratio will be assessed on net transaction accounts over $71mm.

TARP Repayment

The Special Inspector General for the Treasury said that banks need to have a well defined exit strategy to repay TARP and that the Treasury is currently coming up with methodology to determine what discount, if any, will the Treasury accept.

FHLMC Changes

Freddie CEO Charles Haldeman Jr. and Board Chairman John Koskinen both announced that they will step down after replacements are found.

Charter Facts

Since 2000, 300 banks have converted from a national charter to state chartered, while 92 have converted the other way. Bank of New York, State Street and Suntrust are the 3 largest state chartered banks.