LIABILITY AND RISK MANAGEMENT

by Steve Brown

Yesterday we ran into a bank that proudly showed us their innovative deposit product. They had just introduced an "Upside CD." While this CD has been tried before in various forms at other banks, this one allows the customer to get a new rate, one time during the life of the 3Y CD. The thought would be that the issuing bank gets customers to extend out longer than they normally would, as customers feel confident they could change their CD rate in for a higher one down the road. The bank reasoned that rates have not moved recently and are not expected to do so until 2014. This bank showed us their model based on an elegant Excel spreadsheet, using a single number for the average of interest rates over the last several years. The bank assumed a single value of 20% of customers would request the higher rate. In exchange, the bank issued the CDs at about a 10% discount to like-termed CDs. They were proud that the CD was meeting with great demand. Unfortunately, we had to refer them back to yesterday's article and point out that they might have fallen into the trap of not looking at risk with an eye towards probability and not taking into account serial contingent risk.

A couple flaws quickly surfaced during the discussion that we bring to your attention to prevent similar issues. First, the forward curve projects rates will go up more than 10bp, so many of those balances will be at a net loss should those depositors choose to increase their rate in the future. Next, the bank failed to take into account the volatility of interest rates. Intermediate rates could swing widely during the next few years. Essentially, the bank has sold an option for about 80% of the value. Finally, in this bankÃ¢Â€Â™s model, they used an average rate, without respect to the potential distribution of rates AND assumed that only 20% of the population would exercise the option as a static number. While the bank might be right if rates go up 15bp and only 20% will go through the trouble, the bank never looked at the scenario should rates go up 100bp (how many customers would redeem). If you worked through the model and either assigned probabilities or simulated interest rates, it turns out that the bank has about a 71% percent probability of losing money on this product.

At present, there is an odd dislocation between market rates and longer term CD pricing that runs contrary to popular opinion that deposit rates are as low as they can go. Banks still have plenty of room to reduce their rates. For example, the LIBOR curve used to track pretty close to the FDIC national average deposit curve. The Swap curve used to track above the national average curve for longer-term CDs. In the last few months, however, the LIBOR curve has risen and has been splitting the difference between the FDIC national average rates and the rate caps, while the Swap curve has flattened and is tracking the longer-term CD average rates. More to the point, the dispersion of rates in many markets is wide, with an average of 130bp for savings accounts and 170bp for 5Y CDs. This is unusual and is sending a signal that longer term rates at banks are relatively high. Given we have had low rates for longer than we have had above average rates, the sensitivities of the deposit base have materially changed as well.

As of the end of December, 95% of community banks had a cost of funds above the average of national banks. Half the banks in this country have interest bearing deposit rates above 95bps. This hurts performance in a market that has a national average rate of 31bp for a 1Y CD.

Despite high liquidity, banks canÃ¢Â€Â™t take their eye off liability management. Now is the time to restructure your deposit base and reset tiers, add products and reorganize marketing to suppress future rate sensitivity. If you are looking for tips on liability management and bank analysis, consider attending our Executive Management Conference in San Francisco in May. Among other topics, we will cover a variety of issues pertaining to liability structuring/pricing, new product design and risk management to help your bank improve future performance. Sign up today, since the $100 Early Bird discount ends Sunday. At a very low $499, the price of this conference is very cheap, you get CPE credits and you learn many, many ways to make money during this difficult time.

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PCBB 2012 Executive Management Conference

BANK NEWS

M&A Off

Kinecta FCU ($3.2B, CA) and NuVision FCU ($1.2B, CA) announced their Boards had mutually decided to terminate their merger agreement that would have created a $4.4B credit union. The amount of time required to get regulatory approval, integrate the companies and final review were simply too onerous and too disruptive to their members.

M&A On

GFA FCU ($429mm, MA) will buy Monadnock Community Bank ($82mm, NH) for about $6.4mm. Of note, Monadnock was initially chartered in 1971 as AWANE Credit Union, but converted to a bank in May 1996 and changed its name to Monadnock Community Bank in October 2000.

Crackdown

The CFPB has begun accepting consumer complaints about checking accounts, savings accounts, CDs, related services and bank accounts in general.

Slowly Better

RealtyTrac reports bank owned homes and short sales in 2011 dropped to 23% of all home sales, the smallest percentage in 3Ys (the peak level was 37% in 2009) and down from the 26% level of 2010.

Cost Savings

The CEO of Associated Bank ($21.7B, WI) is quoted in a story as saying the 20 branches they closed in 2011 save the bank about $300,000 per location.

Time Needed

Cleveland Fed Pres. Sandra Pianalto (voter) said a frustratingly slow economic recovery means it could take up to 5Ys to get the unemployment rate down to 6%.