STRESSING ABOUT MAY DAY

by Steve Brown

Today is May Day, an ancient time of spring festivals and frivolity. Perhaps that is why Occupy protesters and labor activists are encouraging a general strike across the U.S. In fact, a strike is planned at Los Angeles International Airport by various union members, as well as in cities such as Chicago, New York, London, Toronto and others around the U.S. and the world. Protestors are calling for a strike and urging people not to show up to work, school, not to shop or go to a bank. Clearly, we are at work as usual, sans the festivals or frivolity, as are probably all bankers seeking to keep the economy growing and to make customers happy. What a strange day this may turn out to be. May Day also provides yet another example of why it makes sense to stress test many different things at your bank. After all, if you have to have stress in your day, it may as well be self- induced. We therefore come back to the concept that rising rates could damage loan credit, so stress testing is important. In the old days, it was enough to simply perform ALM interest rate shocks with scenarios of up and down 300bp and then quickly check a few things to be sure the wheels weren't coming off. We found that historically speaking, anyway, when rates rise community bank loans get better and performance improves because the economy is improving. Sure, the borrower is paying more to your bank in floating rate interest, but they are presumably seeing more sales, so everyone is happy. Simply keeping a lid on deposit costs during periods when rates are rising provides banks ample opportunity to help performance. Well, at least that used to be the case anyway. Consider that this time around we are sitting at historically low interest rate levels. So, when rates rise 300bp, the Fed funds rate will only be 3.25%. That rate reflects a still very weak economy, so it is likely that your customers won't be seeing the benefits of stronger business either. Yet, they will have to make a loan payment that is perhaps 100bp to 300bp higher than where it is now (adjusting for floors). When you calculate a small amount of additional business for that customer given a slowly healing economy (remember this is not a V-shaped recovery), combined with a higher loan payment, their ability to service the loan declines. That increases the probability of default, which is counterintuitive to our history, so it is difficult sometimes to comprehend, but nonetheless important to model to determine the potential impact on your loan portfolio. Forget the May Day protests and think about the impact to your loan portfolio if loans that were carrying debt service coverage ratios of 1.5 to 1 suddenly dip down to 1 to 1 or less. Knowing exactly how much a rise in rates will impact each loan (at least those where you are concentrated) and taking steps now to protect the bank are important. You have time, given the modest economic recovery, but time is not unlimited so it is important to get started now. Figure out which loans could see the most stress, talk to the borrower, restructure if necessary and see about fixing the rate for a longer period of time as you keep it floating on your books through an interest rate hedge. Just make sure you take the steps to fully understand the impact on each borrower in turn (and then in aggregate) should rates rise. Thinking about rising rates right now might seem crazy given it seems like a long way off, but it will happen sooner than you think. Working now to restructure loans with lower appraisals or that would deteriorate from a credit perspective if rates climb can be a process unto itself so it is good to begin when you have plenty of time to deal with everything. In the meantime, if you would rather celebrate today than protest, consider these major events that occurred on May Day in year's past - Special Forces killed Osama bin Laden (2011); the 125th Kentucky Derby was held (1999); the Amtrak Railroad began operation (1971); Mr. Potato Head was introduced (1952); the Empire State Building was dedicated (1931) and Ford became one of the first companies to adopt a 40-hour work week (1926). Enjoy the festivities as you reduce your stress.

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BANK NEWS

M&A

PacWest Bancorp ($5.5B, CA), will purchase American Perspective Bank ($264mm, CA) for $58mm in cash, or about 1.4x tangible book.

M&A

The Bank of Hampton Roads ($1.9B, VA) will sell 3 branches to First Bancorp ($3.3B, NC) for an undisclosed price.

Fed Lenders

The Fed's April Senior Loan Officer survey showed C&I loan demand increased last month, as more businesses requested credit lines for inventory, accounts receivable financing, M&A and infrastructure growth. In addition, consumer mortgage demand increased, while other consumer lines were stable.

Floating Treasuries

Some banks are considering the purchase of new floating rate Treasury Notes that are expected to be announced later this week. They have a low yield, but carry little credit, liquidity or interest rate risk.

Private Banks

FASB will include privately held banks in the definition of a "private company." The definition is important, as previously financial institutions were not considered private and the designation exempts these non-public banks to reduce reporting requirements (such as the ever present fair value disclosures). We note that SEC filings are still up for debate.

Housing

According to the Census Bureau, the home ownership rate hit a 15Y low in 1Q, falling to 65.4% (peaked at 69.2% in 2004). Meanwhile, rental properties had a vacancy rate of 8.8% in Q1, the lowest level in about 10Ys.

BofA

As part of "Project New BAC," the Bank announced it will cut 2K jobs in investment banking, commercial banking and its non-US wealth management units.