GET RID OF YOUR 3-MONTH CDs TO INCREASE WINNINGS

by Steve Brown

Poor Alex White. In 1995, White matched all 6 numbers in a major lottery. The problem was that instead of winning the $27mm pot himself, he had to split it with 132 other lucky winners for a mere $206k payout - talk about disappointment. The incident highlights that fact that while the odds are the same for matching all 6 lottery numbers (approximately 175mm to 1 for a common 46 number game), the expected winnings may not be. This is why serious students of the lottery pick numbers above 31 (people love to pick their birthdays and 7, 14 and 18 are by far the most popular numbers); around the outside of the grid (most people gravitate towards the center) or pick consecutive number strings. Use this strategy and while your odds of winning will not improve, the expected value of your winnings doubles. In similar fashion, many banks choose to spend more energy on their CD issuance than their money market accounts. We bring this up as most banks have their money market and 3-month CD account priced at the same level at around 13bp these days. In a "normal market" with a steeper yield curve, this difference would be 25bp or more. Ironically, for banks that do the math, it is the money market account that is more valuable than the CD, and pricing the money market near the CD rate hurts this value. As veteran deposit officers will tell you, it is not so much the maturity that is important, but interest rate sensitivity. While the calculation of interest rate sensitivity has to do with finding both the duration and positive convexity for each product (something called "deposit product gamma"), simplistically, you want the least interest rate sensitivity when rates go up (but the longest duration from the bank's point of view) and the most when rates fall. Similar to the expected lottery winning calculations that rely on more than just figuring the odds, smart deposit managers know that building value is a function of gathering liabilities that exhibit the least sensitivity to interest rates movement. The average money market account at community banks, for example, has duration higher than a 3-month CD and multiple times the convexity. The lower the rate on the money market account, the less interest rate sensitive those account holders are and the greater the ability a bank has to lag pricing when interest rates are going up (and drop them quickly when rates fall). As such, the money market account deserves much greater attention than CDs. When 1 and 3 month CD rates are similar to money market accounts it confuses the customer's (and bank employees) view. Of course, the problem comes in when banks try to pay too much for their money market funds. In this market, 25bp seems to be an inflection point on the demand curve. Once banks post above that level for money market rates, they end up destroying value, by dramatically increasing interest rate sensitivity and thereby decreasing the net value of those deposits. In general, most banks do themselves a disservice by offering a 1 or 3-month CD at all, since it gives customers too close a point on the perceived maturity scale. That ends up making the money market account more rate sensitive just by the CD proximity. Price the money market account too high on a relative basis and banks end up eroding the value of the money market account by drawing funds into 3-month CDs that have a shorter duration and less convexity. Three months is a time horizon that most businesses and consumers rationalize as being right around the corner, so many account holders may go back and forth between the two depending on rate. A better move is to get rid of your 1 and 3-month CD offerings altogether (start your CD ladder at the 6 or 9 month mark). This removes comparisons and forces an implied calculation on the individual preference for the time value of money. In this manner, both business and retail customers will place more emphasis on the money market account's flexibility, which should result in lower rates and greater net value to the bank over time. Do this the right way and you may find that like your expected lottery winnings, your money market account value may double.

BANK NEWS

M&A

AmericanWest Bank ($2.3B, WA) will acquire Inland Community Bank ($221mm, CA) for $23.7mm in cash or about 0.95x book.

Student Lending

The Education Department and the CFPB have released a report showing total outstanding student loan debt is more than $1T (as of 2011) and $150B was in private student loans (of which, cumulative defaults were $8B). Amid surging defaults, private student lenders required 90% of loans to be co-signed by a parent (up from only 67% in 2008).

HARP

Refinancing grow, as in May alone, 22k homeowners who owe more than 105% of their home's current value completed refinances through HARP. That was up from 15k in Apr. and only 4k in May 2011.

Business Weakness

Analysis of the most recently available Census Bureau data finds that between 2009 and 2010, about 70% of U.S. metropolitan markets (and 78% of the top 100 largest markets) saw a decline in the number of private sector businesses operating in them.

Ratings Cut

Moody's cut the credit ratings on 13 Italian banks by one to two notches, reflecting the ongoing malaise that grips Europe. Moody's cited an increased risk that Italy might be unable to provide financial support to its and said the banks had substantial exposure to the domestic economy and sovereign debt.