Bursting Balloons

by Steve Brown

Balloons filled with helium rise and fly away because helium is lighter than air. As a balloon rises, there comes a point at which the density of the air is the same as the balloon and the helium inside it. This is a point of equilibrium. As such, shouldn't there be a large number of party balloons sitting around in the atmosphere at the altitude of equilibrium, from years of releases by small children at birthday parties? It's a fun idea, but science also shows that as

a balloon rises, atmospheric pressure decreases. In response, the balloon expands and pretty quickly everything goes KABOOM! The altitude at which this happens for a standard party balloon is estimated at about 28,000 feet.

This brings to mind the financial markets of the last few days. The FOMC met on June 18 and 19. Market traders and the financial press have been mumbling for quite some time about when the Fed intends to begin tapering / reducing its quantitative easing (QE) bond purchases, which have stood at $85B per month for awhile now. Talking about it a lot in fact, as more than 1,200 news articles in the month of May alone used the words "taper" or "tapering," up from a level of 0 before. A quick Google of "Fed tapering" showed 91mm+n results.

In the press conference following the most recent FOMC meeting, Chairman Bernanke outlined a possible timeline for the tapering, beginning later this year and into 2014. In addition, in its economic forecasts the Fed estimated the unemployment rate could come into range of the 6.5% target for a possible rate increase in later 2014, as opposed to the 2015 most had been expecting. This should be good news, but change is tough.

Bernanke's comments were the balloon at 28,000 feet moment, atmospheric pressure could no longer support it and there has been a great explosion. By the end of the trading day a few hours later, Treasury yields were up more than 20bps and equities had fallen more than 200 on the Dow. The carnage continued the next day, albeit with other factors sprinkled in (a worrying credit crunch in China and banks needing more capital in Britain). The driving force though, was the Fed's statement, which seemed pretty much in line with what all the people-in-the-know had been saying for weeks.

Equities tumbled in part because there is concern about whether the economy can grow with higher interest rates. The Fed has indicated they will taper bond purchases if the economic expansion appears sustainable. There has been some discussion however that the Fed might pull back on its expansionary policies in response to other secondary effects, like the easy money cycle creating a bubble in junk bonds.

Community bankers enduring tough competition over commercial loan business can relate to the bubble concept. Plenty of bankers have wrung their hands trying to figure out if the rate they need to accept in order to win business is enough to take on the risk of any given commercial credit. Cross selling and ancillary fee business helps make relationships more profitable, but it does not help with the credit risk question, which can ultimately be much more concerning for the bank.

It is an interesting question whether the Fed will start pulling back its bond purchases due to concern over asset bubbles, regardless of whether the economic trends support a sustained expansion. This is perhaps what is causing the markets to expel gas at a great rate over the last few days.

BANK NEWS

M&A

The Croghan Colonial Bank ($630mm, OH) will acquire National Bank of Ohio ($219mm, OH) for cash (30%) and stock (70%) worth about $28.9mm or roughly 1.4x capital.

Easing End

A Bloomberg survey of economists projects the Fed will reduce QE to $65B starting in Sep and end all purchases in Jun 2014.

Arbitration

The Supreme Court ruled yesterday that contracts that require customers to go through arbitration and waive their class-action rights are permitted under the Federal Arbitration Act and courts may not invalidate them.

Fined

Bank of Tokyo-Mitsubishi agreed to pay a $250mm fine for processing 28,000 payments worth about $100B for blacklisted countries such as Iran.

Mobile

A recent study by Varolii Corp found 48% of people surveyed have not yet downloaded a banking app, while 44% are already using one, up sharply from 2Ys ago.

Competition

Studies find only 21% of large banks still offer free checking to customers. One reason is that the same studies find people with $1,000 or less in their account will choose free checking (54%) much more so than people with more than $5,000 in their account (20%). It appears large banks are proactively pushing less valuable customers to other institutions by charging for checking.

Complaints

A study by the FTC finds of the 8mm consumer complaints it received last year the most prevalent were for: fraud (52%), identity theft (18%), debt collection (10%), banks and lenders (6%), shop at home or catalog sales (6%), prizes/sweepstakes/lotteries (5%), imposter scams (4%) and internet services (4%). Meanwhile, looking at the method of contact, most fraud complainants said email (38%), phone (34%), internet (12%) or mail (9%).

Strategic Planning

An OCC report does a good job by indicating at a high level a bank's strategic planning process should answer four questions - where are we now (SWOT); where do we want to be (mission, goals, objectives); how do we get there (strategies, contingency plans, capital analysis) and how do we measure our progress (metrics, reports).