The Numbness of Feeling Sensitive

by Steve Brown

If you whack your elbow just right, like while trying to catch a closing door because you are carrying too much stuff, it can hurt and create a numbing buzz that extends to your fingertips. As you howl in pain, you are likely to drop the entire load in your arms. For those bankers that always wanted to be a doctor, the tingle comes from impact to your ulnar nerve, which is the largest unprotected nerve in your body. It is most commonly called the funny bone, which likely came from a doctor who found its location around the humerus quite funny indeed.

Bankers aren't commonly known to be funny, but they too can become sensitive when it comes to the use of models and how those models are used to measure the impact of various things on bank performance. Banks use ALM models, stress testing models, interest rate risk models and all other sorts of models to measure the depth of their sensitivity. In an industry so reliant on models, it makes sense then, that regulators want to be sure the assumptions being used in all of these models are good ones. The problem is that just like all generalizations are wrong (including this one), all assumptions in models are wrong - or at least are sometimes. You see, banks base management decisions on the output of models and the choice of assumptions can change the conclusions, so care must be taken.

PCBB has regularly recommended banks do a sensitivity analysis or essentially "stress test" the assumptions that are the basis for models. While this tactic seems like it could open up a world of crazy possibilities, there is something specific banks should look for. In some cases, using a different assumption could have almost no effect at all on the final outcome. But in other cases, changing that assumption could show a radically different result. Given that knowledge, the bank gains a better understanding of where its sensitivities lie and can take any action necessary to protect itself as needed.

Let's take an example. A bank assumes that if there is a 200bp rise in interest rates, its deposit costs will increase by 50% of that (100bps). This assumption is based on the behavior of customers in its non-interest bearing and savings accounts. The relatively lower increase in rates is driven by those types of accounts over time deposits.

However, customer behaviors have changed over the last few years. There has been little benefit in being in a time deposit vs. a non-interest bearing deposit, so many customers have transitioned. It's just not worth the bother to lose flexibility for 25bps. Given our scenario of a significant rise in rates, customers are likely to become more interest rate sensitive and move to time deposits. How much and how quickly, we don't know, but if customers move in droves to time deposits, things change for our sample bank. Such deposits have a much shorter duration and require higher interest rates so the bank's assumption on its cost of funds could be radically different than reality. Couple the shorter duration deposit portfolio with a lengthening duration loan portfolio (as customers stick with low fixed rates loans) and the bank may be feeling numbness spreading given the whack of this significantly different interest rate risk picture than anticipated.

To protect your bank and be prepared, test your assumptions, stress everything and see where your bank's sensitivities lie. Then take steps now to be prepared when this zero interest rate environment eventually ends.

BANK NEWS

M&A

The parent company of Independent Bank ($1.8B, TX) will buy Collin Bank ($204mm, TX) for about $29.1mm in cash and stock.

Branch Purchase

Washington Federal ($13.1B, WA) will buy 51 Bank of America branches in ID, NM, OR and WA for an undisclosed sum. The branches hold $1.8B in deposits and $11mm in loans.

Branch Purchase

Chemung Canal Trust Company ($1.3B, NY) will buy 6 Bank of America branches in NY for an undisclosed sum. The branches hold $261mm in deposits and $1.8mm in loans.

Branch Purchase

City State Bank ($264mm, IA) will buy 5 Liberty Bank ($333mm, IA) branches in IA for an unnamed sum.

M&A

Arsenal Credit Union ($186mm, MO) will acquire Southern Illinois Area CU ($8mm, IL) for no money exchange.

Accused

Steven Cohen, billionaire founder of hedge fund SAC Capital Advisors, has been accused by the SEC of failing to supervise employees for illegally trading equities based on insider information. The SEC said Cohen ignored red flags and failed to follow up to prevent violations of law. SAC has already agreed to pay $615mm in fines. A key trader in this case was charged in Nov. with what prosecutors call the biggest insider- trading scheme in history.

Customer Preferences

A survey by GoBankingRates.com finds 41% of respondents prefer banking with local community banks, 34% favored credit unions and 23% like national banks.

Customers Leaving

A Capgemini survey finds the Top 5 primary factors customers say they leave a bank is due to: the quality of service (53%), fees (50%), interest rates (49%), ease of use (49%) and quality of advice (44%). Items ranked the least important were recommendations (22%), reward or loyalty programs (28%), brand image (29%), personal relationship (34%) and product availability (37%).

Dodd Frank

The latest research from Davis Polk finds 3Ys into the rollout of this legislation, out of a total 398 rulemaking requirements 39% have been finalized by regulators, 28% have missed the deadline but have proposals released, 16% have missed the deadline without a proposal, 16% have a future deadline without a proposal yet and 1% have a future deadline with a proposal released.

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