Painting a Changing Picture

by Steve Brown

There is a novel by Oscar Wilde called "The Picture of Dorian Gray". It was first published in 1890 and was considered quite scandalous at the time. The story focused on a handsome young man who had a portrait painted and sold his soul so his own beauty would not diminish over time and the picture would age instead. Over time, the portrait reflected the man's life of debauchery and the growing disfigurement of the painting gave evidence of the destruction of his character. While not to the same gravity as selling your soul, particularly depending on the skills of the artist, face painting gone crazy can certainly produce stares and muttering at times.

No matter what artist is hired at this point, bankers know even selling their soul won't change things back as the entire industry has been repainted with regulatory brushes. The picture is still changing, but general complacency in the industry around funding (given the protracted low interest rate environment and overabundance) are definitely all around. We have seen banks continue to take on risk by using a familiar funding tactic that works fine as long as rates remain steady. The amount of potential interest rate risk that banks may find on their balance sheets as interest rates rise, however, is another matter entirely.

It is not news that the average maturity of loans has extended significantly (especially true in community banks). The number of loans with maturities over 5Ys for banks under $1B in assets has increased from 14% in 2007 to 27% as of Q1 2013. That near doubling has regulators concerned and bankers are beginning to face questions about contingency plans, stress testing and other factors during recent exams. To be sure, business customers want long term fixed rate loans right now and competition is high. Those conditions have pushed bankers to offer rates where most are not comfortable holding the loan for a long period of time.

The issue that has potential to cause distortions and problems though is on the funding side. Banks are quite liquid right now and many have very low loan-to-deposit ratios, so few are worried about funding. Some have begun to utilize FHLB advances once again to match-fund longer maturity loans.

That helps interest rate risk management, but there are a number of problems with this approach. Consider that if the loan pre-pays, the bank no longer has that income generating asset, yet it cannot unwind the funding without significant cost. Given modest prepayment structures in loans, this can be a bigger problem than many may be thinking about. Further, with FHLB advances, the bank is using wholesale deposits support loan growth. That draws heavy regulatory scrutiny as it is not "core" funding. It also uses up contingent liquidity and requires collateral. That adds pressure and takes away flexibility. Finally, consider the greatest enterprise value of a bank in a rising rate environment. Deposit costs lag the overall rise in interest rates and profitability soars, as retail deposit costs remain far below the cost of institutional deposits.

Instead going wholesale, consider instead booking a floating rate asset right from the get-go. This can be accomplished by putting a hedge on the loan that allows your bank to float the asset while your customer gets a long term fixed rate loan and you fund it with core deposits.

As you ponder the points we have discussed today, give us a call to find out how easy it is to use a hedging tool without all the muss, fuss or face paint.

BANK NEWS

M&A

German American Bancorp ($2.0B, IN) will buy United Commerce Bank ($132mm, IN) for $15.3mm in cash & stock.

Core M&A

Davis + Henderson Corporation (Canada) will buy Harland Financial Solutions (HFS) for $1.2B in cash. HFS offers bank software (core, lending, compliance and channel management) to 5,400 US bank, credit union and mortgage company customers and is the 4th largest provider of core banking software. HFS' lendign platform includes LaserPro and Davis in past years purchased Mortgagebot, Avista Solutions and Compushare. Davis provides technology to 1,700 US bank and CU clients. Harland Clarke Holdings will continue to provide integrated payment solutions, security and transactional printing, marketing services, security and identity protection solutions, retail products, business process outsourcing and data management/assessment.

Branch Sale

The Bank of Maine ($785mm. ME) will sell 6 branches in ME to Machias Savings Bank ($963mm, ME) for an undisclosed sum. The branches hold $75mm in deposits.

Branch Sale

Hancock Holding Company ($19.2B, MS) will sell 7 branches in TX to Texas Dow Employees Credit Union ($2B, TX) for an undisclosed sum. The branches hold $30mm in deposits and $34mm in loans.

Branch Sale

Hancock Holding Company ($19.2B, MS) will sell 3 branches in LA to Sabine State Bank and Trust Company ($738mm, LA) for an undisclosed sum. The branches hold $30mm of deposits and $20mm in loans.

Basel III

Changes to regulatory capital will likely drive larger banks to change the way they invest. To address the capital impact of price movement in their investment portfolios, look for larger banks to take actions that include: shortening their duration, moving more securities to HTM, holding more loans vs. securities, holding more capital or buying more floating rate securities. Community banks should take note, as this will begin to impact pricing in these areas in the months to come, as larger banks adjust to these new realities.