# Following the Trend or Not

by Steve Brown

A recent exhibit at the Metropolitan Museum of Art in NYC called "Punk: Chaos to Culture" illustrated the influence of punk culture on high fashion. It ended up drawing in almost 450,000 visitors, becoming one of the most visited exhibits in the history of the Costume Institute. Punk as a cultural movement whether in fashion or otherwise, has always emphasized rebellion over conformity. The popularity of the show brought about an interesting existential question: if punk is popular and trendy, plus if it makes it to the MET, is it still really punk?

Bankers may not consider the rebellious image of a punk to be an attribute in a business environment, but we would like to propose how being a punk could be more attractive than conforming to the trend. The trend of which we speak is putting the bank's primary effort into growing its loan portfolio by bringing in new customers. Loan portfolios have been shrinking since the beginning of the financial crisis and this has caused contraction of NIM, as banks have had to rely on the securities portfolio or cash equivalents to generate earnings.

As we speak to bankers around the country, they report spotty new loan business, but the competition is fierce. It is good news that loan activity is slowly rising, but overall portfolios are still shrinking due to prepayments and payoffs. These in turn have been due primarily to runoff of existing customers from banks under $1B into banks over $1B, after customers are presented a better offer from the competition and leave.

Studies show it costs 5x to as much as 16x more to bring in a new customer than to keep an existing one, so it is critical to keep those you already have. To do so, you must be very proactive or the competition will eventually find your best customers and try to take them away.

One way to do this is to produce a list of all loans coming due in the next 18 months. Then sort them descending by size so you know which ones will have the most impact if they leave. Then proactively approach these customers with an offer to refinance their existing loan in return for a longer-term one. This is called "blend and extend" and it usually works quite well. The key is to make your move long before maturity to keep competition at bay and to focus on customers that will have the biggest impact first.

It is also important to protect other loans in the portfolio. These include fixed rate loans with 2Ys or more to maturity at above market coupons, fixed rate loans without adequate prepayment protection and floating rate loans secured by real estate.

There are a number of reasons banks resist approaching customers to refinance their loans ahead of maturity. These include a concern the customer may shop the rate and leave anyway, as well as losing existing coupon through the loan's maturity date. Given such extreme competition right now, chances are very high they have already been approached by others, so this is largely moot.

Prepayment protection is part of the lending business and it has historically helped bankers maintain their portfolios, but many popular structures have not succeeded in keeping loans in place. To reduce future risk of other competition punks from reaching into your loan portfolio customers and refinancing them out from under you, consider using yield maintenance provisions to add even stronger protection.

Put your primary emphasis on retaining the loans you already have in your portfolio by identifying, refinancing and structuring them in a way that keeps them around. It's a little less exciting than bringing in new customers or going to a punk rock concert perhaps, but it also carries a higher likelihood of success.

## BANK NEWS

**M & A**

Prosperity Bank ($16.3B, TX) will buy F&M Bank & Trust Co. ($2.4B, OK) for $47mm in cash and stock.

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The Gratz Bank ($188mm, PA) will buy Liberty Savings Bank ($28mm, PA) for cash equal to adjusted book value.

**2Q Performance**

The FDIC reports the banking industry earned a record profit of $42.2B in 2Q, a 23% increase from a year ago. The data is skewed sharply towards the largest banks however, as it shows the primary drivers for the increase were lower loan loss provisions and higher trading income (and not loan growth).

**Branch Purchase**

Merchants Bank ($1.3B, MN) will buy a few branches in MN, along with $47mm in deposits and loans from Associated Bank ($23B, WI) for an undisclosed sum.

**Investment Risk**

The 2Q FDIC report shows banks took a $51.1B hit to unrealized gains for AFS securities, marking the biggest drop in history. An upward shift in interest rates and holding longer duration securities in the securities portfolio (as banks chased yield in prior quarters) were the primary cause.

**Muni Risk**

A federal bankruptcy judge has ruled the city of San Bernardino, CA may proceed with bankruptcy.

**Hedging**

2Q FDIC data finds over 20% of institutions (1 in every 4.9) now have derivatives on their books.

**DIY**

BAI reports a partner at Novantas says banks "aggressive" with self-service and alternative technologies are seeing as much as a 10% per-year reduction in branch transactions.

**Wealthy Gen Y**

Ipsos research estimates 15% of Gen Y (ages 24-35) make more than $100k.