Monsters Under the Bed

by Steve Brown

Nearly everyone has experienced monsters living under the bed. References abound in movies and books. We even found an 11-step program on the internet to eliminate monsters and it includes some good lessons for bankers. For example: obtain a detailed description of the monster; believe in its existence; eradicate the monster in all the dark places it hides and perform regular and careful inspections to be sure the monster situation is supervised and under control.

In banking, the monster hiding under the bed right now is interest rate risk and regulators are keeping up a steady stream of commentary around it. They are concerned about interest rate risk on bank balance sheets and want to be sure asset and liability management processes are sufficiently robust to handle rising rates and that bankers are prepared.

To be sure, the drawn-out low interest rate cycle of the past few years has been very difficult for banks. Margins have compressed as loans have repriced or run off. As bankers have struggled to maintain earnings, they have been left with a paradoxical situation. Staying liquid generates almost no return, but is safer than locking in long term assets at low interest rates that will get hit hard when rates eventually rise. Compounding the issue, research finds about 75% to 85% of community bank revenue comes from interest income, so it must be generated.

To do that, as loans have repriced, community bankers have seen interest income decrease. In such environments historically, the alternative asset has usually been securities, but that isn't working this time. Interest rate risk is found in securities and right now yields are too low to cover bank operating costs, so bankers find themselves going longer and longer.

As banks struggle to find yield, assets lengthen but deposits remain short. While some deposits are longer-term, community bank deposits by and large are naturally shorter in nature so a mismatch occurs when assets lengthen. That makes regulators nervous. One concern is that when interest rates rise, demand deposits are expected to be more rate sensitive and therefore of much shorter duration.

There is no easy answer in CDs either. After all, there has been little reason for even rate sensitive customers to chase yield on a CD when the difference only adds up to 10 or 20bps. Further, bankers starved for performance are reticent to push anything but DDAs right now. The risk is that higher rates could change things quickly, as banks could be left with locked-in, longer fixed rate assets and rising deposit costs.

So where is the solution in all of this? We recommend bankers take this approach: First, identify and describe the monster. Be sure your bank's asset and liability process is robust, comprehensive and dynamic. Ditch the weak call report version and focus on instrument level analysis. Next, perform regular inspections to be certain the monster is supervised and under control. Review your bank's investment policies and be certain they meet the needs of a changing interest rate environment. Finally, proactively go after the monster. When loan customers want long-term fixed rate loans, do the transaction to keep the customer, but hedge the risk by changing payments to floating on your own books to better match your deposits.

We all know that interest rates will eventually rise and as we get older we worry less and less about the monsters hiding under the bed from our childhood. To avoid an issue later, however, more needs to be done to ensure the bank has a good plan just in case. Consider the sneak peak we all just saw when speculation increased over the timing of the end of the Fed's bond buying program just a short time ago. Rates shot up 100bps and many lost sleep over the jarring move. To be sure, the timing of a major and consistent rise in rates is unknown, but regulatory concerns serve as a warning to be diligent.

PCBB has robust ALM and loan hedging solutions to help your bank identify, monitor and manage the interest rate risk monster hiding under the bed - call or email to learn more.

BANK NEWS

M&A

LCNB National Bank ($944mm, OH) will acquire Eaton National B&T ($357mm, OH) for $24.6mm in cash.

M&A

In a rare occurrence, Honor Credit Union ($470mm, MI) will buy a branch from Edgewater Bank ($121mm, MI) that includes 850 customer accounts for an undisclosed sum.

Audit Warning

The Public Company Accounting Oversight Board (PCAOB) is warning auditors they need to do a better job to make sure internal controls at companies are strong and protect against fraud.

Branches

Javelin reports 25% of Gen Y (Millennials) born 1982 to 2002 visit branches to open accounts or get advice, but 56% prefer to monitor accounts and balances online. Meanwhile, some 25% to 35% of all customers only interact with their bank using virtual channels.

Online Banking

Research by Adobe finds consumer visits to financial websites are up 27% this year vs. last year and have now hit an all time high.

Mini Branch

Starbucks has taken a page from banks and is now opening what it calls "modern modular stores" that are only 700 square feet in size.