Controlling A Bolt Of Risk

by Steve Brown

In the years from 1920 to the middle of the 1940's, about 400 people each year were killed by lightning strikes in the U.S. This contrasts with 2013 when 23 people were killed by lightning. In 2012 the number was 28 and there were 26 in 2011. Why the dramatic drop in just over 50Ys you may wonder?

Well, the incidence of lightning is certainly out of the control of humans and so far as we know has not declined. There are probably factors like the movement of population from farms to urban centers, but we don't know if that helps or hurts either. Perhaps modernization has played a part, with modern tractors providing a steel roof over a farmer's head, but again we are not sure. Perhaps it is because most modern homes have electricity and plumbing, which makes them safer from lightning. Probably, it is all of that combined.

As with preparing for bad weather and lightning strikes, banks have spent the better part of the last 5Ys learning absolutely everything there is to know about credit risk and battling the epic credit storm that washed through the industry.

The problem is that there is always some sort of lightning ready to strike just around the corner and this time it is interest rate risk for banks. Interest rates further out the curve have been whipping up and down as economic conditions change, leading banks and regulators to monitor things here more closely. Banks are paying special attention to extension in the securities portfolio and the negative hit to capital when rates rise. In addition, small business loan customers are seeking long term fixed rate loans to lock in payments before rates rise further so pressure is all around.

Banks who hedge loans and keep floating rate instruments on their books address interest rate risk for at least part of their portfolio, but what about floating rate loans that don't fit the parameters for a hedge? These might be smaller credits, less secure businesses or customers with less predictable cash flow for instance. While these customers are probably not at risk to flee to a competitor (because they are not as desirable), as interest rates rise these customers will at least pay more interest, so everything can't be all bad - right?

Well, not exactly. The idea works only so long as the customer's cash flow increases at the same rate as the increase in interest rates. We already pointed out that these customers are less secure because of the nature of their business, cash flow and other factors, so more is happening here than meets the eye. Instead of an increase in interest income, these customers could become stressed borrowers faster, so risks are everywhere and may not be readily apparent.

Banks that are taking the risk right now to generate NIM by holding onto longer fixed rate loans without a hedge will see pressure when rates rise, but some continue to justify putting even more on the books despite a pretty full portfolio already. Nothing is easy, margin is needed and you have to keep your best clients so care must be taken and analysis must be ongoing. It is critical right now to be sure you are not inadvertently building an adverse portfolio of credits or selection process that creates the potential for greater credit risk as rates rise.

Hang in there, call us for ideas and keep working with customers who are likely to be at-risk as rates rise. Interest-based credit risk is not random like a bolt of lightning, but is most often foreseeable and with some effort, manageable.

BANK NEWS

M&A

Stockman Bank of Montana ($2.6B, MT) will acquire Basin State Bank ($157mm, MT) for an undisclosed sum.

Big Reserve

French bank BNP Baribas, the parent company of Bank of The West ($65B, CA) and First Hawaiian Bank ($17B, HI), reported it set aside a $1.1B provision for possible penalties under OFAC. The set aside relate to financial transactions it reportedly conducted with restricted foreign countries blocked by the U.S.

Optimistic

A survey by executive search firm Angott Search Group finds 60% of bankers that responded expect current market conditions will provide growth opportunities. Meanwhile, 55% said regulatory oversight and rulemaking were their biggest obstacles.

Servicing

PHH Mortgage said it has retained JPMorgan to help it sell off its mortgage and auto fleet leasing business lines.

LCR

U.S. banks are lobbying hard to make sure regulators understand the liquidity coverage ratio (LCR) under Basel III that requires U.S. banks to hold enough easily sold assets to survive a 30 day credit downturn could hurt them. The rules are different than international standards and could negatively impact competition with foreign banks.

Consumer Regulation

The Fed has proposed repealing Regulation DD (Truth in Saving Act) and Regulation P (consumer information privacy), saying its rules are "substantially identical" to final CFPB rules in these areas.

Biz Strategy

A Deloitte survey of executives, directors and risk managers at companies' worldwide finds the biggest technology enablers or disrupters that most see threatening their business model are: social media (47%), data mining and analytics (44%), mobile applications (40%), cloud computing (38%), virtual or augmented reality interfaces (17%), digital fabrication (8%) and cyber attacks (36%).

Construction

The Census Bureau reports homeowners spent $130B on remodeling projects in 2013 vs. $126B in 2012 (a 3.1% increase). This was the highest level of remodeling spending since 2007.