Keeping It Simple

by Steve Brown

Numerous studies show that brain function can be improved by learning new things throughout one's life. Especially beneficial is learning in areas unassociated with a person's regular work, like crossword puzzles or a language for people who work with numbers, or number games for people who primarily work with their verbal skills. One medical study showed that the actual anatomy of the brain changed and was more active when new words were brought into use. We thought we would offer a word for bankers that is not only new but useful as well. Among the Eastern Canadian Inuit group that speaks the Inukitut language, the word for "simplicity" is katujjiqatigiittiarnirlu.

Times are complicated in the banking industry and almost every institution searches for ways to simplify. There is one concept in banking that is unvaryingly simple though and that is the correlation between interest rates and the duration of assets. When interest rates fall, prepayments speed up and duration shortens. Securities portfolios feel the reaction almost immediately in the case of callable agency bonds. Even one basis point downward in rates may prompt an agency bond to be called away. Mortgage backed securities may react a little more slowly, but when rates fall, CPR/prepayment speeds also increase, as the mortgages in the portfolio refinance. Again, duration shortens.

The loan portfolio is a little different in that it takes individuals and businesses longer to refinance, but the trends are the same. In a time of falling rates, prepayments and refinancing speeds up and the bank ends up reinvesting prepaid monies into lower "current market" securities, loans, etc. The longer rates remain low as has been the case, a larger percentage of assets are at lower rates, so bankers begin to go for longer and longer maturities (longer duration) to try and get any decent yield. Then, as rates begin to increase these securities and loans go "underwater" vs. "current rates". Here also, even more customers want to lock in low interest rates because once rates start to rise; borrowers seek to lock in the rates they know vs. a rising tide.

The current interest rate cycle takes us to a place we have never been before. The near-zero short term rates have persisted for so long that it has affected both customer and bank behavior. The Fed has done this on purpose, but the targets for the end of the cycle are moving closer, so bankers must continue to prepare for what lies ahead.

Banks may have reached for yield with longer term securities in order to generate some return, but once rates rise, callable agencies go to full maturity and mortgage-backed bond prepayments slow to a small drip and duration extends.

As rates rise, loan portfolio duration lengthens as well. There is the exception of the borrowers who hold floating rate loans as they may not have sufficient financial strength to refinance. There is real danger here because when rates increase on any floating rate loans, the debt coverage of these customers' declines, perhaps even leading to a real credit issue.

This is why regulators are raising their voices about increasing interest rate risk and the lengthening duration of assets on bank balance sheets. They are also very concerned about the probability of increasing credit risk.

To be sure, banks have both fixed and floating rate commercial loans on the books and the floating rate variety are probably prime-based that have been at the same rate now for years (the floor rate). It's a good idea to take a hard look at your bank's loan portfolio to see what could happen. All of the loans that have been on floors for years can move upwards once rates move higher. While this may sound good as it is a source of interest income, be sure to consider the possible credit risk that may come along with rising rates as well. While the correlation between duration and interest rates is simple to understand, the results on credit, loans and securities are anything but simple. Challenge your brain and your team to find solutions to protect your bank against this eventuality.

BANK NEWS

M&A

The Libertyville Savings Bank ($203mm, IA) will acquire Farmers Savings Bank ($94mm, IA) for an undisclosed sum.

Retail Lending

Reuters reports retailer RadioShack Corp will close up to 1,100 stores throughout the country as it responds to much weaker sales than expected over the holidays. Bankers should double check retail loan portfolios to understand possible exposures.

Bank Insurance

The ABA reports the major insurance policies carried by banks other than financial institution bonds in order are: workers compensation/employer liability (99%), umbrella/excess liability (99%), automobile (98%), general liability (98%), D&O liability (97%), building and contents (96%), employment practices liability (93%), fiduciary liability (92%), safe deposit (89%), kidnap/extortion (89%), OREO/foreclosed property (87%), bankers professional liability (87%), mortgage impairment (85%) and cybersecurity/privacy (81%).

Small Biz

The most recent Thomson Reuters/PayNet Small Business Lending Index finds small business lending climbed 4.0% in Jan vs. Dec. and delinquency has fallen 12% YOY for loans 31 to 90 days past due.

All Buyers

A Keefe Bruyette & Woods survey of regional bank executives finds 82% want to buy another bank and only 13% are looking to sell. Looks like prices will keep rising, so if you are a seller hang in there and you might get more.

Upgrade Coming

CNNMoney estimates 95% of bank ATMs nationwide still run on Windows XP, which must be upgraded by banks to reduce the risk of future cyber-attacks. Experts say the upgrades could cost $1,000 to $3,500 per ATM.