The Penalty Box

by Steve Brown

Icy conditions have been seen all over the Eastern U.S. this winter and it brings hockey to mind. As we witness the techniques and attitudes of drivers navigating winter conditions, the value of hockey's penalty box is clear. Wouldn't it be perfect for the guy who cut you off and almost hit you a couple of miles back! The good news is that no matter the weather, the penalty box is not exclusive to hockey. It also exists in rugby where it is called the sin bin and when you had young children it was called the time out corner. No matter the sport, the concept is the offender sits in the corner for a time-out for unsporting or rough play. While not so rough a punishment as to be expelled from the game entirely, teams can and do use the box strategically in sports. This is where bankers may find some useful ideas.

We know that interest rates will rise in the future and have already seen rates further out the curve move upwards. This is affecting the behavior of securities and loans. Meanwhile, deposit costs have not really changed for most banks as customers remain content to sit in core deposits and wait for time deposit rates to rise in the future. As higher interest rates get closer, customer behavior may change quickly.

What does that say about a bank's existing CD customers? Consider the current FDIC national average rate on a 12 month CD is 20bps. If the rates on CDs revert more towards "normal" levels over time, this could be a move of several hundred basis points higher.

Consider as well that traditionally what has kept a CD customer in place has been an early withdrawal penalty of usually about 6 months interest for early withdrawal. If a customer is faced only with forgoing 6 months interest at 0.20% in order to invest at 3.0% at some point in the near future, how "core" is that customer really and how strong is that penalty? At these low rate levels, an interest-based early withdrawal penalty is unlikely to keep a depositor in the sin bin for long once rates jump higher.

Currently, CD deposits are in general of shorter duration than core deposits. It has been interesting as well to watch the brokered CD market where large issuers have been extending the duration of their funding. This market is mostly made up of big retail banks like GE Capital and Discover, so monitoring trends can give you good insight. We've seen a number of these banks only issue longer maturities recently. Of note, brokered CDs trade like securities with a cusip number and would be sold at market rates should a depositor decide to liquidate, so the depositor takes on the interest rate risk. The banks are extending because they see the forward rate curve moving higher and they want to lock in lower funding costs in the future.

The situation is largely different for community banks right now as we see banks taking on the interest rate risk in almost all cases. For that reason, it is probably worthwhile to consider strengthening your penalty box. There is nothing to be done with existing CDs (and it isn't necessary to go into the brokered CD market), but as your CDs roll over, we have seen banks change from an interest penalty to a percentage of principal plus interest concept. While this may deter some customers from investing in CDs, this may be a valid longer term objective for you. It would not be wise behavior to increase the penalty and also increase the interest rate paid, as then the bank both escalates its costs and encourages customers to be even more interest rate sensitive and to shop according to rate.

How your bank prices deposits going forward is likely to be very important in a changing rate environment. Consider the strategic use of the penalty box to keep your funding costs stable and reasonable over the longer-term.

BANK NEWS

Payment Exchange

The Washington Post reports Capital One ($320B, VA) will let customers exchange money with each other using peer-to-peer (P2P) platform ClearXchange. ClearXchange is a bank network that lets customers send P2P payments using only the recipient's mobile number or email address. Capital One has 65mm customer accounts and it joins Bank of America, Wells Fargo and JPMorgan on the platform.

Apartment Construction

The Wall Street Journal reports the share of housing construction related to rental apartments has jumped to the highest level in 40Ys. Meanwhile, residential construction related to single family homes has declined from a peak of 87% of all housing starts in 1993 to about 67% in 2013.

Auto Lending

SNL Financial reports the top 5 depositories in auto loans as of Q4 2013 are Ally Financial ($51.7B in auto loans), Wells Fargo ($50.8B), JPMorgan Chase ($41.5B), Capital One ($31.9B) and Bank of America ($29.9B). This group alone represents about 58% of the $353.4B in aggregate auto loans at banks and thrifts at the end of 2013.

Debit Fraud

The ABA reports 96% of banks experienced losses from debit card fraud in 2012 and 63% incurred losses from check fraud.

Not Servicing

Major banks dumped their mortgage servicing operations to the tune of $1.03T in 2013, as they aggressively moved to exit due to increased regulation and higher capital charges. As a result, mortgage servicing businesses have shifted more and more to companies outside the banking system and non-bank mortgage servicers controlled 17% of the market at the end of 2013 vs. only 6% 2Ys prior.

Done & Gone

Four large private equity investors (Blackstone, Carlyle, WL Ross and Centerbridge Partners) have sold their remaining ownership in BankUnited ($14.9B, FL).

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