Digging In The Loan Portfolio To Avoid Risk

by Steve Brown

One of the biggest construction projects in Europe called "Crossrail" is underway in London. It is designed to add train transportation infrastructure under the city and giant tunneling machines are tearing through dirt as fast as they can go. Along the way though, workers have unearthed numerous old human bones found just outside the ancient walls of the city. In medieval times, this area was a graveyard for plague victims and it is estimated that the plague killed 75mm people in 14th and 15th Century Europe (including more than half the population of Britain). Scientists are studying DNA from the teeth to learn about the lives of people at the time (high rates of malnutrition and hard physical labor for the poor and many died at a young age). They are also studying the plague bacterium, which at least initially seems to not have mutated very much in all those years. It's hard to imagine anyone picking around our bones 600Ys after our deaths, but just in case, we will be brushing our teeth dutifully.

No one is sure what else these tunneling machines will uncover, but there are things bankers can be sure about - like rising interest rates in the not too distant future. As a result of increased press coverage and perhaps even fear, many bank customers are seeking to lock in a fixed rate on their loans. While you would think logic would dictate people would want to lock in for as long as possible, some banks are finding this isn't necessarily the case. Some customers seem content to lock in for 5Ys and then worry about the rate later on when it is time to refinance. The reasoning is that there is quite a lot of difference between the 5Y rate and the 10Y. The curve is fairly steep, but is the shorter maturity a logical choice?

Fed watchers made note of a number of elements after the last meeting of the FOMC in this regard. In the press conference following the meeting, Fed Chair Janet Yellen remained vague overall, but did give some idea of how long after the Fed finished winding down its asset purchases that it might begin to raise Fed funds rates. Pundits added up the numbers and came up with mid 2015, a bit earlier than some had expected. Even more interesting was the information in the charts the Fed released after the meeting. These charts showed a majority of FOMC members expect interest rates to be at 1% or above by the end of 2015, and between 2% and 3% by the end of 2016. If the Fed Funds rate is 300bps higher in just over 2Ys, the idea of refinancing a loan in 5Ys vs. locking it in now for 10Ys seems like it may not be the best choice - even if the rate to get a 10Y loan is 100bps higher currently. This is the nature of interest rates before a rising rate cycle gets fully underway.

On the other hand, some pundits point out interest rates could remain flat for longer than expected as the economic recovery ebbs and flows and inflation remains very low. In fact, given a Q1 GDP of only 0.1%, that seems plausible and only time will tell.

Still, since most retail customers with HELOCs and other prime based loans have not seen their rates change since 2009, we wonder if they are awake to the risk embedded in their monthly payment schedule. Do they remember that these rates can increase and perhaps even jump sharply? If that happens, are banks prepared for correspondingly higher credit losses?

No one wants to return to the early days of the credit crisis, as those bones are best left buried deep in the dirt. That is why community bankers may want to consider talking to customers that may be carrying exposure now to help them understand the risk and see what you might need to do to be better prepared.

BANK NEWS

M&A

Guaranty Bank and Trust Co. ($135mm, LA) will acquire Bank of Maringouin ($55mm, LA) for an undisclosed cash sum.

SIFIs

The Fed has identified the following as systemically important enough to pose elevated risks to U.S. financial stability and therefore under the supervision of the Large Institution Supervision Coordinating Committee: AIG, Bank of America, Bank of New York, Barclays, Citigroup, Credit Suisse, Deutsche, GECC, Goldman, JPMorgan Chase, Morgan Stanley, Prudential, State Street, UBS and Wells Fargo.

Mobile Activities

The Fed reports the most common banking activities performed by mobile banking users are checking account balances (90%), transferring money between accounts (42%), receiving text message alerts from their financial institution (33%), making online bill payments (26%) and locating an ATM (21%).

Fed Action

Following the announcement to reduce monthly asset buying by $10B on Apr 30, the Fed has $45B remaining. At the current pace and meeting schedule, the Fed will be back to $0 by either 10/29 (if they do $15mm in the final piece) or 12/17 (if they do $5mm in the last piece).

Still Problematic

After conducting stress testing, the FHFA said FNMA and FHLMC might need a bailout of up to $190B in the event of a severe economic downturn.

Social Banking

Bankers using Facebook for social media marketing purposes should note the company has rolled out a new service that will distribute mobile advertisements to smartphones and tablets through independent apps.

Savings

Community bankers looking to build deposits should note CNNMoney polled its readers over 50Ys old and they say the best way to build wealth is through consistent saving (74%) and savvy investing (10%).

Less Competition

A study by the University of Kansas finds households doing business with a single bank save more money than those with multiple banks.