Long Term Exposure

by Steve Brown

As the summer heat hits, we sometimes long for winter--until colleagues remind us that winter weather was brutal last year. You can even freeze to death, don't ya know! Ever inquisitive, we wondered just how long that would take. We thought you would enjoy some fun facts: Actual freezing of the body would occur long after death by hypothermia which sets in when the body's core temperature drops below 95 degrees. Core temperature below 70 degrees results in cardiac arrest. A person submerged in 40-degree cold water will survive approximately 15 minutes. Other variables come into play in the great outdoors, such as the absence or presence of moisture, type of clothing and the environment when considering the time it takes to succumb to exposure. Brrrrr.

Let's consider a different type of exposure. Many banks are currently conducting experiments with long term exposure in the form of long term assets. Some of this has occurred in a stretch for yield in both the loan portfolio and the securities portfolio, and some is due to natural extension of existing portfolios.

A recent article in the Wall Street Journal brought to light the increase in long term assets on credit union balance sheets. This has been going on for some time in banking and we have addressed the issue at length. Credit unions are a bit different from banks because while their products are often indistinguishable from those of banks, the inability of credit unions to raise capital could add a set of different problems. Long term assets at credit unions rose to an all-time high at the end of 2013 at almost 36% of assets.

This increase has come from both loans and securities portfolios, but lending practices are of particular concern. Credit unions have said they are not concerned about the safety of their loans as borrowers are required to have high credit scores and provide proof of income. The largest banks in the U.S. have not extended their duration of assets the same way, but many community banks have, so credit unions could argue that their risk profile is in line with community banks.

Navy Federal Credit Union ($58B in assets) for one is allowing members to borrow up to 100% of the value of their home. In addition, they originated $389mm of zero-down mortgages in the first four months of 2014, up 31% from the level a year ago. Another credit union advertises home equity loans to pay for vacations. There is a whiff of pre-credit crisis in this mix if you ask us. If a borrower takes out 100% of their home value, what happens if their home value decreases and they lose their job? Are any of these home equity loans floating rate, and if so, what will we see when the Fed begins to raise interest rates?

Concern is not only in the loan portfolio. One credit union we saw in the data added long-term investments that resulted in unrealized losses equaling 36% of its net worth at the end of 2013. This was entirely a result of recent increases in longer term interest rates as the portfolio had an unrealized gain at the end of 2012. Many financial institutions oppose stricter rules requiring loss-absorbing capital, but given this risk, is that prudent?

All financial institutions should take care with long term exposure and avoid having too much. Hedging is easy to do and there is no reason to take such a risk with upwardly rising rates (call us to find out more). As with your clothes in the winter, dress your institution appropriately for all the risky conditions that may occur to avoid being frozen out when rates rise.

BANK NEWS

Safety First

A Bankrate.com survey of Millennials finds 39% say cash is their preferred investment for money they won't need for at least 10Ys or about 300% higher than the percentage who said the stock market. For all Americans, 25% said cash, real estate was 23% and stocks came in at 19%.

Generations

Bloomberg reports there are 76mm Boomers (born between 1946 and 1964), 57mm Generation X (born 1965 to 1980) and 82mm Millennials (born 1981 to 2000). Boomers began to hit the retirement age of 65 three years ago.

Social Media

Financial Brand reports a survey by LinkedIn of usage among community banks and credit unions finds 56% of sales people are not allowed to use social media sites at work and only 26% were encouraged to use LinkedIn as a sales tool.

Municipal Lending

The Fed is alerting banks that some loans to municipalities could significantly increase credit risk. They also warn banks that municipalities in areas that are seeing declining demographics and falling real estate are particularly vulnerable.

Booming BOLI

The Fed reports 3,533 commercial and savings banks at the end of 2013 held over $137B in life insurance assets (Bank Owned Life Insurance, BOLI) or about 15.7% of Tier 1 capital + ALLL (how the Fed monitors concentrations). By asset grouping: <$100mm (698 banks, about 37% of banks in this asset size, average 17.3% of Tier 1+ALLL), $100mm to $500mm (1,913; 61%, 15.6%), $50mm to $1B (455, 79%, 15.3%), %1B to $10B (401, 81%, 13.9%), $10B+ (66, N/A, 13.3%).

Better Credit

The Fed reports noncurrent loans to total loans at community banks declined to 1.9% at the end of 2013 vs. 4.1% at the high water mark in 2010. Meanwhile, net charge-offs as a percent of average loans fell to 0.4% at the end of 2013 vs. 1.6% at the high reached in 2009.

Regulatory View

The Risk Management Association (RMA) reported that bank regulators "believe community banks are on the mend", "banks still face challenges with margins and other expenses", "earnings continue to be under pressure" and "continued dialogue (with regulators) is important."