In A Trance And On Hold

by Steve Brown

Having passed the 5th anniversary of the financial crisis earlier this summer and given that the economy seems to be picking up some momentum in most parts of the country, it is a little surprising that the day-to-day lives of bankers have changed very little from a year or two ago. In spite of the predictions of imminent change of one kind or another, we are mostly still in an environment of low loan demand, low interest rates, low yields on securities and impending higher interest rates (but when?). We are also stuck in a world of increasing interest rate risk, from extending asset durations to a high level of core deposits that are likely to revert back to a more normal mix of higher cost time deposits (also, but when?). Is this stagnation due to the actions of central banks around the world or is cause-and-effect a little difficult to ascertain here? Central banks have acted as they have in response to tepid economic conditions, but near-zero interest rates have kept bank balance sheets in a trance-like state.

Some time back, the Fed instituted long-term asset purchases in order to drive down interest rates. Their goal was to stimulate economic growth and it seems to have helped. Since last fall, in an effort to unwind all of this, the Fed has been reducing its purchases of long-term assets by $10B at each meeting of the FOMC. Fed purchases are now less than half of the level of purchases at the end of 2012 when the program began.

Overall, the Fed's asset purchases did result in a drop in interest rates, but they had a larger effect on banks. Banks had expanded their securities portfolios and while yields were low, given the near-zero Fed Funds rate, there was at least some return on securities. Over the years, banks have been buying mortgage backed securities (MBS), so when the Fed began its purchases, there was little supply left for bank portfolios. This drove down rates on securities even further, so with securities yields low, banks turned back to loans. The problem here has been that with lower interest rates and extraordinary competition for qualified borrowers, banks have seen heavy prepayments and declining portfolio yield as loans mature, were repriced or were lost entirely.

Now the Fed is tapering its asset purchases as it seeks to remove the stimulus and reset policy to a more normalized level. Yet, the yield on MBS has not increased much. This is because while the Fed is purchasing less, they continue to reinvest what they already hold. Since the Fed still holds most of the MBS securities in existence that keeps MBS yields low.

The dynamics that keep interest rates low on securities are also in place in the loan marketplace. Here a few large banks hold almost all the issuance (top 10 banks have most of the loans), so demand for loans is very high and yields are declining.

There is no easy solution right now, but at some point we will have a tighter Fed policy. For now, banks should consider adding floating rate credits to their loan portfolios to prepare and to ensure some assets will be accretive once rates begin to rise. For the short run there will be a trade-off in current yield, but this is not a time to be short-sighted.

In such an environment, an easy way to add floating rate credits is by purchasing C&I loans or hedging longer term fixed rate loans you may originate directly. We can help you with both, so give us a call because we are standing by and never compete with our community bank customers. Bank balance sheets will eventually break out of their trance and this will happen when the Fed snaps its fingers and begins policy tightening. Make sure your bank is prepared for that time.

BANK NEWS

Housing

CoreLogic reports completed foreclosures fell 9.9% year over year in June, as 648k homes were in foreclosure.

Complaints

The CFPB reports the largest percentage of consumer complaints in 2013 for all products were for mortgages (47%), credit reporting (13%), bank accounts or services (12%), credit cards (12%) and debt collection (9%).

Changes

A survey of CFOs worldwide by Deloitte finds changes flagged as the least likely to occur at their respective companies are: substantial divestiture (55%), discontinuing operation of a business unit (53%), outsourcing a core business function (53%), substantial deleveraging of capital structure (44%) and major share buybacks (43%).

Social/Mobile

Research from Digital Insights finds 75% of Facebook engagement for a given post will occur in the first 5 hours; 44% of Twitter users have never sent a tweet and 40% of YouTube traffic originates from mobile.

Top Economies

The latest data finds the U.S. is the world's largest economy at $16.7T in economic output in 2013, followed by the EU ($15.8T), China ($13.3T), India ($5.0T) and Japan ($4.7T). Interestingly, if U.S. states were their own country, CA would be the largest at #8 in the world, followed by TX, NY, FL and IL. This group of 5 states is about 39% of total U.S. GDP and if you include PA, OH and NJ you get to 50%.

Strategic Planning

Regulators indicate strategic planning should be dynamic and that planning and implementation should be adjusted to reflect changing conditions over time.

Sensitivity

The RMA reports that as interest rates move, the present value of assets and liabilities also moves. The difference between them is known as the economic value of equity (EVE).

Foreclosure Compensation

The Fed reports about 83% of borrowers have cashed checks reimbursing them for financial injury related to misconduct around home foreclosures during the credit crisis.