Risk And Zeitgeist

by Steve Brown

Zeitgeist is a German noun meaning the defining spirit or mood of a particular period of history, as represented by the ideas and beliefs of the time. Before the financial crisis, the defining mood of the times was that real estate prices would continue to rise at 20% or more per year, that there was an unlimited market for spec-built homes, that construction loans weren't that risky given the dynamics of the real estate market, and that all mortgage-related securities deserved a AAA rating.

The large banks supported this belief (except when they were betting on the other side) and made buckets of money. Community banks were far more careful, but in the end, many bought into the zeitgeist of the moment, at least to some extent. Lending mushroomed in construction and CRE (sometimes without enough collateral) and mortgages were based on refinancing at a later time (with the assumption that the property would appreciate in value). Otherwise, shareholders wanted to know why the bank wasn't participating in the party and making lots of money like everyone else. Most banks ended up with assets on the balance sheet that have required cleanup over the past several years.

We all know this history well and yet there have been a number of reports lately that give us pause. The first was the recent action of Congress to loosen regulations that sought to control the activities the largest banks used to excess. It could be argued that such risky business practices led to the crisis and their eventual bailout.

Among smaller institutions, several credit unions currently offer (at least on their web sites) 100% mortgage financing with no down payment and no PMI. Some also offer mortgage refinancing up to 97% LTV. Have we learned nothing?

Next, the OCC released its annual report on the banking industry and said US banks have been gradually easing their loan underwriting standards and that the current level is similar to standards before the economic crisis occurred. Sub-prime auto loans for financially stretched buyers are surging, up about 15% from 2013. FNMA and FHLMC have even issued new guidelines allowing home buyers to buy homes with 3% down, a reduction from the prior 5% minimum. Finally, the Institute of International Finance reported that global indebtedness as a share of world economic output has reached record levels.

All of this is occurring after an extended period of unprecedented low interest rates, which has altered the perception of both lenders and borrowers of how much debt service is affordable. Banks wrestle with one another over quality loans (and some of lesser quality), lowering the interest rate and easing the requirements with each exchange.

Today's zeitgeist is that lower margins are to be expected regardless of the risk, plus we've worked our way through all those problems already so things will be fine. There is an expectation for an increase in interest rate risk with higher short term interest rates, but less concern over increasing credit risk.

Given all of these dynamics, we caution banks to tread carefully. While history may not repeat itself exactly, it often rhymes. Any time an economic or business condition becomes the "new normal," there is a high likelihood that times are about to change.

Today, stakeholders in banks are fatigued. After the cleanup, it's been exceptionally difficult to achieve any kind of returns in the long low-interest rate environment. As the year winds down, the US has made important strides in the economy and most banks are experiencing far better times than a year or two ago. Don't forget the fundamentals of good risk management and let's keep moving forward.

BANK NEWS

M&A

InterBank ($2.5B, OK) will acquire First State Bank ($22mm, OK) for an undisclosed sum.

Competition

A report by the Fed finds peer-to-peer online lending has exploded at an average rate of 84% per quarter since Q2 2007 vs. 2% for traditional bank originated channels.

Retail Spending

The National Retail Federation projects holiday spending will increase 4.1% this year, the highest in 3Ys. Meanwhile, MasterCard projects retail spending climbed 5.5%. We will have to wait to see who is right once the dust settles in a few months, but both are nice numbers and show consumers are spending again.

Minimum Wage

The Seattle Times reports WA will have the highest minimum wage for any state on Jan 1 when it jumps to $9.47 per hour. OR will be #2 at $9.25. Many cities are higher, but this is interesting information nonetheless as it points to how the states are managing things.

Crazy Growth

Early last week the Commerce Department reported Q3 GDP jumped to 5.0% vs. 3.9% estimated. The huge jump indicates people and businesses are spending money as the economy continues to boom.

P2P

Data by peer to peer online lender Lending Club finds 83% of loans are used to pay off more expensive credit card loans. We wonder what the percentages are for people who just borrow again and leverage up their credit cards vs. those that keep that debt paid off.

Patches

The NY Times reports a neglected upgrade to a server gave intruders access to 76mm records during the breach reported on Oct. 2.

Lower Still

Reuters reports oil prices may fall to $20, as the market enters a phase similar to the period from 1986 to 2004.