A SHOCKWAVE IS COMING

by Steve Brown

As a supersonic jet flies through the air it creates pressure waves. Those waves, traveling at the speed of sound, are compacted together, eventually merging into a sonic boom. We have been around the finance industry long enough to know when it feels like a sonic boom may be coming and it seems the time is near. Over the past few years, independent banks under $10B have seen exceptionally strong loan growth, historically low losses and widening net interest margins. As the FOMC reaches the apex of the rate cycle, however, these banks are likely to show signs of stress. To begin, the yield curve has flattened since June 2004, as long-term rates have held relatively steady, while short rates have climbed. This has pushed higher credit quality borrowers to seek the safety of longer rates, increasing demand for long-term fixed rate loans. While independent banks have been able to weather most of this effect through a combination of asset sensitivity and by originating wider margin construction loans, a sonic boom seems inevitable. NIM is poised to come under increasing pressure in coming months. The cost of funding assets for independent banks has also been rising and recently there are signs it may be accelerating toward the speed of sound. Some banks have begun paying money market rates as high as 5.25% and 1Y CD rates are approaching 6.00%. At the same time, national banks have continued to implement a strategy of reducing their dependence on interest income, allowing them to offer lower rates on loans (as profitability is supplemented by the fee component). As of the end of 2005, national banks derived nearly half of their revenue from fee income, making these banks much less sensitive to yield curve movement and NIM. The result has been a steady decline in large bank NIMs to a 25 year low of 3.29% estimated for June. Banks should note that NIM in the industry has fallen 11 of the past 12 years, so this is not new. Risk appetites will grow. The simple fact is that the longer the yield curve remains flat, the more margins will contract and the more likely it is that independent banks are going to be to take additional risks to hit yield and return bogeys. The flat yield curve is also not going away anytime soon. Look no further than the forward curve, which shows yields will only climb 3bp over the next 5 years. We intuitively know that projection will be wrong at some level, because projections always are. However, it is important to note that by definition the forward curve incorporates all available information at hand, so it is also the single best predictive source. As a result, banks will need to continue to increase fee income sources to offset lower loan and higher deposit coupon rates. Banks will need to adapt to this environment by expanding and modifying their business platform, aggressively controlling costs, taking new and targeted risks, adding structure to both loans and deposits and by exploring strategic growth opportunities. Absent of these strategies, a growing alternative is to slow growth and focus instead on profitability. Given that independent banks like to fly at supersonic speeds, however, a sonic boom seems inevitable.

BANK NEWS

Acquisition

Southern National ($132mm, VA) will acquire 1st Service Bank ($140mm, VA) for $13.1mm, or about 1.6x book.

Branch Acquisition

First Banks Inc. ($9.4B, IL) will acquire three local branches from MidAmerica National Bank ($154mm, IL) for an undisclosed sum.

Potential Sale

In an effort to reduce their non-prime mortgage exposure, National City ($147B, OH) is considering the sale of 2 mortgage units, National City Home Loan Services Inc (PA), and NationPoint (CA).

Insurance Acquisition

Wachovia Corp. ($4B, NC) acquired US Insurance Underwriters (FL), marking the company's first entrÃ©e into the Miami insurance market.

Wal-Mart ATMs

As part of a recent test, Wal-Mart has introduced a pilot program of ATMs that it owns and operates, sparking concern among bankers. The retail giant declined to say how many and where the all the test program machines are located, except that they are in states that don't require them to partner with financial institutions. One such machine is located at the front of a NJ store and bears a "Wal-Mart Money Center" logo. In addition to free cash withdrawals, shoppers can buy phone cards and pay Wal-Mart credit-card bills.

Customer Base

Independent banks will need to deepen their customer relationships if a recent study is any indication. In it, the study found that in just 4Y, 41% of small business principals will be aged 65 or older and that 50% said they would sell or close their business prior to retirement.

Employee Cost

Recent studies show that rising healthcare costs continue to burden banks that buy coverage for workers, retirees and their families. Since 2000, premiums have risen twice as fast as overall inflation and earnings. The total cost for a family of four will be $13,382 in 2006, up 9.5% from 2005.