RUNNING HARDER FOR 4Q

by Steve Brown

There is a motivational analogy that goes something like: "Every day on the plains of Africa, the gazelle wakes up knowing that it has to run faster than the fastest lion to avoid being eaten. Every morning, the lion wakes up knowing it has to run faster than the slowest gazelle in order to eat. Moral Â– When the sun comes up, it does not matter who you are, but you better start running." With the beginning of October, we start a new quarter in banking that has more than the usual significance. During 2005 and the first part of 2006, it was hard not to look like the fastest gazelle in banking. Without credit problems, any bank can look good. Add double digit growth to the balance sheet and bankers looked exceedingly fast to their boards. However, it is the dawn of a new day. Without the Fed raising rates, the inverted yield curve, higher delinquencies, funding problems and concentration issues, starting with 4Q, banking becomes markedly harder. For the first time in years, the last 2 months marked the start of credit quality deterioration and dramatic margin compression. Consider in 2005, banks passed on 28% of the Fed increases to their customers in the form of higher rates on liabilities. During the first half of 2006, that number jumped to 62% which indicated greater rate sensitivity (despite what their ALCO reports said). For 3Q, when the final tally occurs, this ratio should be close to 125%, as the Fed hasn't moved rates, but, due to the inherent time lag, funding costs have continued to increase. In addition to interest rate sensitivity, funding costs have increased (note the distinction we make between funding cost and interest rate sensitivity). When rates were rising and bankers could lag rates and high performing banks could fund themselves at 60% of Libor. Now, banks will struggle to stay under 75%. Loan growth is starting to slow, particularly in real estate and fee income generation is starting to become depressed. After hitting a record low in 2006, loan loss allowances will have to be increased at many banks, hurting earnings. During tougher times, items like more active management of the balance sheet, relationship profitability, loan pricing and deposit strategy become multiple times more important. Boards need to be prepared for the situation that will occur in the not too distant future that a greater level of credit write-offs will have to be taken and earnings are no longer at record levels. Regulatory and accounting pressure on items like split-fee BOLI treatment, FAS 155, continued BSA enforcement and higher risk management standards for loan concentrations will present a host of additional hurdles. Management teams will have to roll up their sleeves and start asking the question Â– How can I survive off lower margins. Smart bankers that have always run hard and smart will now pull away from the pack, while the slow will be eaten in greater numbers. 4Q 2006 will be a transition quarter to a more difficult time in banking and one more representative of 2007.

BANK NEWS

Integration

JP Morgan completed its acquisitions of Bank of New York's retail operations over the weekend and now rolls out an expanded ATM network and retail platform as of today. JP Morgan will add 400 ATMs to its existing network and will pick up 700k new customers. Branding and systems integration will occur in the next phase slated for 4/07.

Insurance Bank Profits

The WSJ, using SNL data, reports that banks owned by insurance companies are more profitable than the average community bank and make up 5 of the top 20 fastest growing banks in the U.S.

Regulatory Relief Bill

The legislation has cleared Congress and now awaits the Presidential signature.

Non-traditional Mortgage Product

The final guidance has been issued that focuses banks on increased underwriting standards and risk management for loans that have payment deferral options, such as interest-only and option-ARMs.

Internet Bank

Wamu has indicated that they are averaging 1 new account every 2.5 minutes at their new Internet bank. The Bank has one of the few websites where you can open an account entirely online.

SOX Impact

A new study by S&P finds the number of directors serving on more than 2 boards has dropped 13% over the past year, to a total of only 6%. In addition, the percentage of CEOs that holds more than one outside directorship has fallen by 21%.

C&I Lending

Several industry analysts predict that C&I growth will be the number one profit driver for banks as real estate and consumer lending slows and credit spreads widened. Average C&I growth is predicted to be 8.5%, or above the 6% predicted for real estate transactions.