PHYSICS AND BANKING:

by Steve Brown

Harkening back to school, one will recall that physics is the study of matter and energy. It examines the forces that cause a body to be put in motion. In short, physics attempts to assess the amount of all forces acting on a body. In banking, one certainly doesn't need to have a physicist on staff to know that every day there are many different forces pressing, pulling and otherwise impacting the industry. To begin, consider the yield curve. In its current inverted state, bankers know their customers will want to extend the maturity on their loans. After all, if the rate offered on an immediately floating rate loan is higher than a 10 year fixed rate loan, what customer in their right mind opt to stay short and be subject to market risk. Why not go longer instead and be assured of the rate for an extended period of time. It is easier to budget, it gives the customer a lower initial payment and it removes uncertainty. Studies show that people will tend to choose the simpler option presented when faced with uncertainty. This problem on the asset side also leads to a problem in funding. The sweet spot when it comes to borrowing money for independent banks has always been 1 year or shorter. In addition, hot competition in money markets and checking has driven banks to raise rates there as well. This results in shorter liability duration and increases the mismatch to assets. Faced with high customer loan demand for longer-term fixed rates, the industry has no easy way to match up the risk by borrowing longer (FHLB costs eat up too much of the margin in a flat rate environment, so banks tend to increase short-term borrowing in the hopes the situation corrects itself). The result over time is a drop in lower cost longer duration deposits as investors change behavior and shift funding to the higher yields offered at the shorter end of the maturity spectrum. This contracts the total amount of longer duration core deposits banks hold as a percentage of total deposits. Consider also for a moment that these forces have been a key reason why the cost of funds for banks above $100mm in total assets has also reached its highest level in 23 quarters. Bankers simply do not want to lose hard earned customers and are driven to grow, so they often capitulate on the lending side, while having few funding options further out the curve. These forces exacerbate the impact on asset and liability sensitivities and can increase risk. The more the see-saw is loaded up short on funding and long on lending, the more EV also gets out of whack and policy guidelines are exceeded. Since bankers are only human, a simple solution is sometimes sought. Consider a recent survey of 100 bankers we conducted that finds about 18% simply widened their policy limits. Perhaps even more disconcerting is that more than 3x as many had not developed a good solution and as such were finding growth very difficult to come by (i.e. customers want longer loans, the bank does not, so customers are forced to find other providers to accommodate their needs and refinance away). Whether independent banks feel they are being pushed or pulled by customer behavior, force acceleration is definitely at work. One of the most basic laws of physics is that a body in motion tends to stay in motion. Bankers will have to apply an equal amount of force to stop this movement.

BANK NEWS

M&A

BOK Financial Corp ($18.1B, OK) is buying First United Bank ($173mm, CO) for $43mm or 1.99x book.

SOX 404

The SEC said that it will not grant an extension to filing for the implementation of SOX Section 404 for non-accelerated filers. Those that haven't adopted will be required to sign-off on their financials for fiscal periods ending Dec. 31, 2007 and have auditor attestation on internal controls by year end 2008. In addition, the SEC issued related guidance on ways to improve annual evaluation of internal controls.

Thrifts

According to the OTS, thrifts posted a 15% earnings gain in the 1Q compared to the same period last year. ROA was 0.97% (up from 0.89%), NIM reached 2.81% (up 10bp) and capital to assets held at 10.7% (stable). Of note, delinquent loans to assets increased from 0.7% in 4Q to 0.8%.

Credit Cards

The Fed has proposed changes to credit card disclosures to make them easier to understand. Modifications include fees, interest rates related to balance transfers, cash advances, late payments and over the limit charges. In addition, a 45 day notice would be needed to change terms instead of the current 15 days.

Unbanked

CA and TX may copy NY's unbanked plan by providing increased municipal deposits at or below market rates and reducing property taxes for banks with branches in specifically targeted areas.