DEALING WITH A NORMAL YIELD CURVE

by Steve Brown

As we were recently touring the French Quarter in New Orleans, marveling at the post-Katrina rebuilding effort, a banker in the group said something insightful and profoundly moving. He said, "Drinks are on me, I'll expense it." The comment hit a responsive chord in our soul and got us thinking (if nothing else to substantiate the business expense) about all the corporate spending that is now driving the economy. Banks, municipals, non-profits and corporations remain active in spending which should help push GDP to an annualized run rate of 3.5% (versus a 2.4% estimate a couple months ago). Non-manufacturing ISM, one of the most reliable economic predictors of growth, is now at 59.7, the highest level in a year. Corporate earnings, as a percent of production are at their highest level in 8+ years. Most of all, employment is solid and is expected to hit a low point of 4.3% in the next couple of months. Less than 4 weeks ago, many economists were calling for a housing crisis that would tip the economy into a recession. These same economists are starting to call for a 6.00% Fed Funds rate by 1Q '08. While it is too early to know for sure the direction of rates, the yield curve is now back to its normal shape which brings a whole new set of problems for bankers. Rates have moved up 50bps in the last 30-days and some of the implications are important. Those banks that have adopted FAS 159 are now most likely second guessing themselves, as losses were recorded for fixed rate assets as rates spiked up. Despite their trepidation, it is only a matter of time before these banks learn to declare a duration natural set of assets and liabilities (when bank's DDA balances are able to be declared under FAS 159) and are able to take their risk practices to the next level. This is exactly what FAS 159 was intended to do and early adopters are gaining valuable experience over how to better manage risk. For banks that did not opt for the early adoption of 159, they have the same risk and the same market movement of value, they just don't know it. Other implications of normalizing rates include more fixed rate loan demand, as the media reports the trend of higher future rates and borrowers rush to lock in rate certainty. Higher rates will cause all lending to slow, but most elastic or sensitive will be mortgage and construction loans (both residential and commercial). On the liability side, higher intermediate term rates will put even more pressure on margins for asset sensitive banks as funding costs will increase, but prime-based loans will remain unchanged through this quarter. Look for the cost of CDs to increase by approx. 15bp, while MMDAs are projected to increase by 11bp for the quarter. DDAs are expected to increase 7bp for the quarter (2bp of costs and 5bp of interest expense). On the asset-liability side, the recent increase in rates has given banks an opportunity to validate assumptions. True to form, the preliminary data shows that both assets and liabilities have shortened in duration over the past year, as loan prepayments continue to run fast and the effective duration on non-maturity deposits have decreased by an estimated 20% on a year-over-year basis. As business continue to spend and the equity markets continue to do well, look for this shortening trend in ALM to continue. It has been since Dec. of 2005 when bankers last faced a normal semblance of an upwardly sloping yield curve. During that time, much has changed and bankers need to be sensitive to how the current interest rate environment will affect their balance sheet. While the last 45 days has negative implications for the future, we expect the observed interest rate sensitivity to moderate. If it doesn't, bankers might all need a couple rounds of cocktails.

BANK NEWS

M&A

Porter Bancorp Inc. (KY, $1.1B) has agreed to acquire Ohio County Bancshares Inc. (KY, $104mm) for $12 million in cash and stock, or 1.3x book.

SAR

The Financial Crimes Enforcement Network declares that any evidence used when filing a suspicious activity report should be kept for up to five years after submitting the SAR.

Staff Increase

Wachovia announced its plan to hire over 300 private bankers in the next 3Ys, a 125% increase in its private banking staff size. Hiring will be target FL, TX, CA, and NY and focus on households with $250k to $5mm in investable assets (projected to increase 30% between 2005 and 2018).

End to FDIC Premium-Free Insurance

Last week, the FDIC announced their renovated premium schedule. The expected charges are 5 to 7 cents for every $100 of domestic deposits for healthy banks, with troubled banks paying more. In order to bring the reserve ratio back to its target of 1.25%, which is projected to be reached by 2009, the agency expects to charge $2.5B next year and $2B in the first half of 2009.

New Feature

MasterCard Product Graduation is a new feature offered by MasterCard that allows its cardholders to retain their same account numbers when upgrading cards or switching products.

Rejected "Say on Pay"

Shareholders of Countrywide Financial rejected a proposal to give them an advisory say on pay packages for the company's top executives. Despite the widely criticized hefty compensation of Chief Executive Angelo Mozilo, only 32% of shareholders favored the bid.

Amex

The Company said it will discontinue its prepaid health-care cards, rumored to be due to lower than expected profitability.