LEVERAGING CAPITULATION

by Steve Brown

Let's face it Â– banks are in the business of leveraging capital in order to provide a fair return to shareholders. Deep inside, doing so also helps them sleep better at night. Over the past year, we have spoken to thousands of community bank executives. Nearly every one tells us a grim tale of NIM compression and extreme competition. Interestingly, those industry pressures have driven many community bankers to do exactly what psychologists would have predicted. You see, as human beings we follow a distinct psychological pattern of avoidance, denial, anxiety, fear, loathing, panic, disbelief and eventually capitulation. We'll get back to psychology in a minute, but first let's set the stage. We intuitively know that a flat yield curve (where long-term rates are at or below short-term rates), changes customer behavior. This fact alone will drive customers to seek the greater stability and lower pricing of long-term fixed rate loans (compared to the uncertainty and higher cost of floating rate loans). We also know that large banks want a big piece of the small business customer, so competition is running very high. Almost in orchestrated fashion, large national banks have decided to open conduits and create 10Y fixed-rate lending programs to attack community banks and acquire small business customers. The problem for community banks is that most absolutely despise originating long-term fixed rate loans. Prime is the index of choice and historically, 90% of origination has been tied to it. Times have changed and customers have more choices, but many bankers we talk to refuse to adapt (the disbelief stage) to meet competition head on. After a laborious process and the passage of time, most eventually work through the psychological pattern outlined above and reach capitulation. Many bankers have already done so, albeit sporadically. For instance, how many readers of this publication, after becoming worried about losing another customer (it costs 5x as much to find a new one), have reluctantly caved in and originated a 10Y fixed rate loan? From our conversations, we know many are in that camp. As the loan is made, most bankers try to convince themselves that everything is fine. After all, the bank does not intend to do very many fixed rate loans and this is handled as a "one-off." This is denial with a little bit of anxiety and fear creeping in. For most, originating a 10Y fixed rate loan and putting it on the books creates significant problems. First, most community banks find easy funding usually between 1 and 6 months. Next, banks that tap the FHLB to fund these longer loans drive up their funding cost (due to collateral and capital stock charges). Worse yet, many banks "short-fund" and leave themselves exposed by "guesstimating" loan cashflows and funding some short and some medium. This process boosts interest rate risk and likely results in a future margin squeeze. Further, this strategy blows up economic value (EV). Quick analysis indicates most banks can put only 5% of their loan portfolio in long-term fixed before EV exceeds policy limits. We know many banks that have doubled or even tripled their policy limits to stay in compliance, but regulators do not take kindly to such tinkering to fix the problem. Finally, banks will have to deal with FAS 157/159 in less than 6 months. This will require such long-term fixed rate loans to be marked to market, in at least the footnotes of the financial statements. Heretofore unobservable price erosion in the loan portfolio will now be dragged into the public spotlight and the bottom-line impact will be exposed and reported. Substantial footnote disclosure and carryover from the subprime lending mess will drive many bank investors to focus on stock holdings and weed out weaker performers. Banks that embrace hedging can put on virtually an unlimited amount of long-term fixed rate loans, use up underleveraged capital and stay within policy limits. Wherever you are on the psychological spectrum, consider beating the rush and capitulating. There is no reason to wait to fully leverage your capital, boost ROE and generate and enhanced return for your shareholders. Large banks are pitching customer choice and customers are listening. Call us and we'll help.

BANK NEWS

M&A

Northrim BanCorp ($980mm, AK) will acquire Alaska First Bank & Trust ($60mm, AK) for $6.25mm or 1x book value.

M&A

People's United Financial ($11.7B, CT) will acquire Chittenden Corp. ($6.7B, VT) for $1.9B or about 2.7x book. The combined entity will have about $22B in assets.

Housing

The latest report on housing indicates sales prices declined for the 10th straight month, while the supply of unsold homes jumped to 8.9 months, its highest level in 15Ys.

Key Kleared

The OCC and Fed lifted their consent orders for Key Corp that stemmed from earlier BSA violations. The Bank added controls, strengthened its policies, improved audit checks and increased employee training.