A WORD ABOUT FED FUNDS

by Steve Brown

In the last few days of last week, it took the concerted effort of Central Banks around the world to avert a complete shutdown in the credit markets. The FRB, along with the Central Banks of Europe, Asia, Australia and Canada; all opened their pocketbooks and literally flooded the market with cash (injecting $154B on Aug. 9 and $136B on Aug. 10). As a result, by Friday, Federal Funds rates had tanked to 0% (the market was overloaded with liquidity) and the only bank bid was reportedly sitting at minus 1%. The FRB even put out a very rare statement, saying they made the move to "provide liquidity to facilitate the orderly functioning of financial markets." The last time the FRB flooded the market with so much cash occurred on Sept. 14th 2001, following the 9/11 attacks. What many may not be quite as aware of, the primary driver for the unprecedented Central Bank action was a credit crunch that began when bank lenders [spooked by the subprime mortgage meltdown and the closing of hedge funds by Bear Stearns, BNP (France's largest bank) and others], became worried about the creditworthiness of some of the biggest financial institutions. As a result, banks significantly increased the rates they charged each other to borrow (pushing the overnight lending rate up to a 6Y high), because they were having a hard time determining who was creditworthy and who might not be. Credit lines to banks, securitization conduits, REITs and hedge funds were either cut outright or significantly reduced. Things have become so bad that at this point, investors are building in rate cuts and taking shots at the FRB and ECB - who they say are so far behind the curve they will have to do emergency rate cuts to bring back financial stability around the world. Whether investors believe the Central Banks have overreacted or not, the situation is clearly still evolving. It is not inconceivable that an easing could occur if market conditions deteriorate further. The bottom line is that bankers the world over are finding out the hard way that not only are model prices not the same as actual bids, but that the subprime debacle has extended all the way around the world. What has been the impact on community banks, you may wonder. Those with large Fed Funds positions relative to their balance sheet have been hit with low yielding investments, putting a material damper on earnings. Volatility is likely to continue for awhile, so these banks may want to consider steps to put some of this money to work in other investments to diversify some of this risk. Other community banks may want to review credit lines. While we are not suggesting bankers haphazardly cut such lines, we would suggest prudent investing and diversification may be called for at this juncture. This discussion also dovetails nicely into the Pacific Coast Bankers' Bank "As Agent" Federal Funds program, a diversified investment pool. On Friday, with such extreme volatility and rates dropping precipitously, many community banks could not find anyone to take their money. Seeing the issue and reacting quickly, PCBB demonstrated its commitment to community banks by stepping up and providing its clients with near-Fed Funds effective rates and liquidity until the close of trading. By proactively reducing credit exposure through a diversified pool, constantly monitoring credit lines and spreading the investment risk across approximately 30 or more larger banks per day, the pool served its function and protected community bank customers. Contrast this to banks that sell to 1 or 2 institutions per day or do not invest in a diversified pool and it is easy to see how the risk mushrooms when markets become volatile. As Friday's events demonstrated, banks that are not diversified Fed Funds investors may be carrying previously unseen liquidity risk (even when liquidity is rampant in the system). Bankers that are not yet a client of this diversified pool are urged to reassess both the credit of their Fed Funds counterparties and the operational risk of their process. As for credit, while rumors were flying Friday about the demise of such entities as Goldman Sachs, Countrywide, WAMU and Bear Stearns, it is unlikely that these are the institutions that you have to really worry about (since they have the experience and resources to manage through such crises). What concerns us the most is the myriad of hedge funds, REITs, smaller banks, brokerage firms and others that we have yet to hear about.

BANK NEWS

M&A

The HC for Mechanics and Farmers Bank ($261mm, NC), will acquire Mutual Community Savings Bank ($93mm, NC) for nearly $3.2mm, or roughly 0.48x book.

M&A

Fidelity Homestead Savings Bank ($808mm, LA) will acquire Your Bank ($49mm, LA) for approximately $7.8mm, or roughly 2x book.

Bank Friendly Bill

The Senate introduced a bill that would let FHLB's guarantee tax-exempt bonds, making it easier for independent banks to finance local projects.

More Woes

In an SEC filing, Countrywide disclosed that it may have to retain more of its mortgages holdings than previously planned due to recent market turmoil, a move that could negatively impact its earnings and financial condition.