GET A HARDHAT

by Steve Brown

Far be it from us to say the sky is falling like Chicken Little, but by anyone's standard, we have seen large pieces of the stratosphere raining down. To talk about the market's current ruminations as a subprime or housing "correction" misses the point. This might have been the case back at the end of July, but now the markets have spiraled into a full scale vortex of illiquidity and insolvency. Problems in the subprime space have migrated to mortgage companies, banks, mutual fund companies, hedge funds, REITs, investment banks and the securitized market. Any time commercial paper and securitization markets seize up, you have issues. Large banks and finance firms have been caught with collateral on their books and are now being forced to take write-downs that will hit their bottom line (and eventually capital). On a scale from 1 to 10, 10 being a major and systemic negative change, we put things at a "7" leaning towards a "9." As with any crisis, it is always a race between liquidity and asset values and we believe we are going down to the wire on this one. Before you think this is someone else's problem, we can tell you that community banks are no longer spectators. Several weeks ago, we took solace in the fact that CRE was still holding up. In the last 2 weeks we have toured office and retail space in NY, D.C., Dallas, Portland, Seattle and Los Angeles and we can tell you that office and retail leasing is now a buyer's market. REITs and U.S. real estate funds are down sharply. Households are looking at their 401k plans and feeling sick. Asset managers and hedge funds have been forced to deleverage quickly and already locked in losses that will soon show up on account statements. More pain is likely, as lower net worth starts to crimp consumer spending, which in turn will hurt corporate earnings. Before we get more doom-and-gloom, there is a silver lining as this market also breeds opportunity. In fact, during strategic planning meetings across the country, we are recommending our clients take certain steps now to mitigate risk and take advantage of opportunity. Bankers can begin by devoting more resources to enterprise risk management. In a more volatile market, risk comes from many directions including operational and credit. If a firm like Countrywide can have issues with funding and deposit run off, it can happen to any community bank. Knowing an aggregation of risks across customers, products, departments and operating companies can improve decision making. Community banks are learning the hard way that exposure to related residential developers was a large risk that probably never made it to Risk Management Committee review (ALCO should be broadened into a risk management committee if you have not done so already). Banks should double check liquidity lines to make sure they are still around. Lines should be diverse, coming from different geographies and in different forms (repo, fed funds, holding company lines, etc.). Banks should slow asset growth and focus on earnings stability. Use this time to decrease asset size by paring back credit exposure through loan sales and participations. Banks will hear more desperate pleas for credit from their customers in coming months, so now is the time to allocate resources to higher-quality credit lines. Finally, banks should build cheap liquidity. The drop in rates and a flood of money from the stock market, hedge funds and mutual funds, gives banks an excellent opportunity. Marketing on safety and service should be increased and lower cost deposits should be used to drive off higher priced funding. While we may be crying the sky is falling, just remember that the little guy was eventually right.

CALLABLE CDS

With the fall in rates, many bank clients are thankful that they issued callable CDs a couple of months ago. These banks can now call this funding and capture more than 40bp of annual savings. We continue to recommend this tactic, so if you are thinking about it, we would like to issue for you. Send us an e-mail and we will contact you with updated rates.

BANK NEWS

FOMC Cut

The FRB unexpectedly cut the discount rate by 50bp and said it is "prepared to act as needed" to mitigate risk to the economy from subprime market dislocation. It did not cut the Federal Funds rate. The Fed said it cut the discount rate because the downside risks to the economy have increased "appreciably," financial markets have "deteriorated" and credit conditions have "tightened."

M&A

Eagle Bank Inc. ($155mm, KY) terminated its merger with Community Trust Bancorp and will be acquired by First Corbin Bancorp ($848mm, KY) for $40.8mm, or about 2x book.

Rate Cuts

Goldman Sachs said the FOMC will cut the Fed Funds rate to 4.50% by the end of this year as the Fed struggles to combat a growing liquidity crisis.

Crisis Update

In an attempt to reign in the credit crisis, the FRB flooded the market with $88B in extra liquidity this week, about 43% more than average. Meanwhile, Moody's cut credit ratings on 691 securities (valued at $19.4B original face amount) backed by subprime loans.

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