BIG BEN'S FIRST CHIME

by Steve Brown

The Fed surprised almost everyone by slashing both the Fed Funds Rate and the Discount Rate by 50bps each yesterday. This was the first downward move since 2003 and the first move under Bernanke's leadership. More surprising was the fact that the vote was unanimous. Although the move will not heal the ailing credit markets overnight, the injection of liquidity will help the capital markets cope with unusually high cash demands. Perhaps more importantly, it gives down-and-out ARM holders a chance to reset lower or lock in a fixed rate loan. In general, we are not fans of the move, as it raises the probability of higher inflation in the long-run and encourages capital to seek more risk given return in the short-run. However, now that the cut has occurred, the question is, how will this help banks? The answer, in our opinion is that it will be a slight negative in the short-run and a larger negative in the long-run. First, the obvious Â– As we learned when rates were moving up, most banks, despite what their ALCO models say, are asset sensitive. As a result, when Prime resets down liabilities don't move as fast, so margins are compressed. Smart bankers try to compensate by aggressively cutting liability costs, but the competition does not always cooperate. The problem is, as our Liability Coach clients know, liabilities have not only become more interest rate sensitive, but also more negatively convexed. That is, they lose more value when rates go up than they gain when rates come down. Money market deposits are one area where banks should see the largest impact. As of today, all banks should be paying 50bp lower rates for MMDA accounts. Some banks will think they can gain a competitive advantage and choose not to lower rates as much, hurting margins for all. For CDs, banks will have to wait until maturities come due, so this part of the liability structure will lag. Banks that have not already begun to lower their interest bearing deposit rates, or ignored advice about being cautious on term extensions, will feel the squeeze from lower rates the most. Banks that are still offering goofy rate promotions will also feel pain, as we have recently seen a number of banks issuing CDs at rates above 5% - even this morning. With market rates moving down rapidly, even a shorter-term CD (such as 5 mos) will seem like an eternity. For DDA's, lower rates make non-interest bearing deposits less beneficial so shareholder value will be lost. On the asset side, banks with prepayment penalties and floors on their floating rate loans will fair the best. Here again, negative convexity raises its ugly head. Banks that haven't been keeping their eye on loan value, will find the value of their portfolio much lower this morning compared to yesterday. The loss of interest earnings will be exacerbated further by a spike in loan prepayments in coming months. Projections show Prime will drop another 75bps by 2Q, so prepayment penalties and loan floors remain extremely valuable. Banks will also pick up about 7bp to 20bp of extra margin over the next 6 months because of the steeper yield curve. Offsetting this negative impact is the fact that credit quality will increase for the short-run. For floating C&I loans, debt service coverage will be enhanced. For real estate loans, the picture is mixed. For loans on existing properties, lower rates help the cash flow of leasees, property cash flow DSCRs and will lower cap rates in turn. However, the largest issue banking has right now is in construction and development loans. Banks utilizing our Credit Stress Analyzer, know that this rate cut will not have a large impact on the performance of their problem construction and A&D loans. Because these loans are non-cash flow dependent, cap rates are projected to improve an immaterial 0.2 in most areas. In summary, lower short-end rates will hurt margins at community banks more than help. Credit quality will improve, helping bank performance. However, this effect will be muted, due to the current nature of problem credits, sector concentration and the negative effects of loan prepayments. Banks that aggressively lower deposit rates and seek structure that limits optionality on the loan side, will gain a competitive advantage in the marketplace.

BANK NEWS

Prime

All major banks cut their Prime rate yesterday, effective today, following the FOMC 50bp announcement.

M&A

U.S. Bancorp's Elan Unit will acquire the card portfolio of the HC of CommunityONE Bank (NC) for about $4mm.

M&A

The HC for Center Bank ($1.9B, CA) will acquire First Intercontinental Bank ($232mm, GA) for about $65.2mm, or roughly 2.96x book.

Housing

A new research report projects close to 50% of the 450,000 subprime borrowers whose mortgage payments reset in the next 3 months are likely to lose their homes. These borrowers face an average monthly mortgage payment increase of 26%.