THINKING ABOUT THE EMERGENCY RATE CUT

by Steve Brown

With the Dow poised for its worst open since 2001, the Fed stepped in and unexpectedly cut the target Fed Funds rate 75bp to 3.50%. The Fed's last cut between meetings was Jan. 2001. The last time rates were cut 75bp was Oct. 1984. Rumors of a 50bp and 100bp cut have been circulating for the last two weeks, but with the global equity markets in complete disarray, the Fed decided it needed to take strong action. The move partially worked as equity markets have stabilized down 300pts (vs the expected down 750pts). However, this raises the question - what kind of leadership is our Fed showing? What economic indicators changed to warrant an emergency move? The timing appears amateurish at best and like panic at worst.

In the Fed's defense, this isn't your father's credit market, so all bets are off. The Fed tried to finesse the situation with market talk and the TAF liquidity, but now it has decided to take a sledge hammer to rates. Given significant losses in large bank earnings, continued problems with liquidity, increased unemployment and slower consumer spending; the move may have not only been warranted, but may not have been aggressive enough when viewed through the lens of history. Since the Fed is more correlated to the market these days, it is important to understand what the market's further expectations are to global rates. First, the market now expects the ECB to cut rates aggressively next week. Second, the market is expecting a more aggressive stimulus package from the White House. Third, the market is betting that the Fed will cut rates as much as 50bp at next week's scheduled FOMC meeting.

The question is what can community banks do? First, banks need to take more of a leadership position. In uncertain times, business owners need someone to turn to for assistance. Marketing messages that play up safety, stability and liquidity will go far to gather deposits. Given the problems with large banks, community bankers can gain ground. More economic information, increased proactive planning and advice are all needed. In addition to positioning lines of credit to customers (with higher than historical fees), a fantastic campaign is to start a program to help stable customers purchase their buildings in light of falling real estate prices and lower interest rates.

Community banks also need to enact contingency capital plans. Banks should consider deleveraging. The best way to do this is to shrink the balance sheet by letting loans run off, realigning credit mix to achieve greater diversification, reducing expensive funding and increasing capital ratios. Doing so gives banks added insurance should the US economy be heading into a recession. Increasing reserves, taking write downs early and keeping your regulators informed are all highly advised. Remember that almost half of bank capital sources are no longer available (trust preferreds, perpetual preferreds, etc.). As a result, banks should revise their capital plans to tap holding company loans or go back into the equity markets at reduced valuations. In our models, 20%+ of banks are projected to have problems. If true, banks that place themselves in better financial position will be able to take advantage of upcoming market opportunities.

Finally, banks should reconsider their asset-liability plan. Pricing for loans and deposits needs to be reanalyzed in light of downsized targets. If banks increase marketing, more deposits will flow in that are less interest rate sensitive. The absolute last thing you want to do is attract money because of safety and then train them to be rate sensitive.Banks should consider ways to permanently capture this longer duration money. Please note that this should not involve locking depositors in for longer maturities. As our Liability Coach clients know, this has, and will remain, a recipe for disaster. Liability duration will come naturally. Capture new money in DDA and MMDA accounts rather than CDs. Brokered CDs and FHLB rates should be taken advantage of to replace more expensive retail money. Public funds need to be reassessed. With rates moving 50bp to 75bp lower at a time, bankers should increase monitoring of loan prepayments and deposit changes for insight into their balance sheet. Smart bankers have already run scenarios to understand how curve shape changes effect their balance sheet. Today is a perfect example of why running dynamic shifts in interest rates is important to understanding how curve flatteners and steepeners can effect loans and deposits.

Market uncertainty is upon us, volatility is everywhere and bankers will have to do more work. However, with additional uncertainty lies additional opportunity.

BANK NEWS

Bank Earnings Pounded

Large banks reported 4Q earnings and the news was horrible. Wachovia said earnings fell 98%, as it took a $1.7B write down in certain portfolios and set aside $1.5B to cover bad loans. KeyCorp said earnings tanked 83%, as it set aside $363mm in loan losses, a 684% increase over the same period in 2006. Bank of America reported profit fell 95%, hurt by $7B of losses tied to write downs and rising credit woes. Finally, Region's profit sank 80%, as residential developers soured amid a weakening housing market (loans to homebuilders make up about 8% of the bank's portfolio).