OF DENTISTS, TOOTH FAIRIES AND BANKING

by Steve Brown

Some time ago we came across a survey that asked people how much money the Tooth Fairy had left under their pillow. You might be interested to know that the range was 25 cents to $20, with an average of only $1.70. We don't know about you, but as a child, we loved to lift up the pillow in the morning to see how much money had been left underneath it from the evening before.

These days, community bankers everywhere are lifting up their proverbial pillows, as they try to predict how much money will be left in 2009. This year looks like it will be extremely difficult, so like visiting a dentist, we examine the situation to see where cavities might be forming (after all, no self respecting Tooth Fairy will cart off a tooth riddled with cavities).

To begin, credit costs are rapidly rising as material credit deterioration is now occurring at many community banks. Driven mostly by an aggressive slowdown in construction and development lending, credit deterioration is both rapid and ruthless. Bankers will need to spend much more time managing credit quality this year and will have to sharply reduce growth expectations.

As if that weren't enough, we project that many community bankers will also have to deal with weakness in their C&I and CRE portfolios. Some C&I credits are closely tied to the housing sector and stresses are beginning to occur. In like fashion, we also expect CRE to see more strain as the year continues.

To protect the quality of the loan portfolio, bankers should continue to reinforce a strong credit culture by tightening standards; focusing on both individual credit and overall portfolio performance; enhancing stress testing; improving loan tracking granularity; and being prepared to immediately attack problem credits as soon as issues arise.

We predict margins will remain under strain throughout the year and even into next year. There are many reasons for this, but some of the biggest are: competition continues to be strong in most areas, bankers still want to grow their balance sheets, more loans are going into nonaccrual (reducing overall interest levels) and the FRB has also been aggressively easing (which slams returns as deposits cannot reset as fast as Prime or Libor-based loans reset lower).

As credit deterioration continues to gather steam, we see loan growth slowing as banks tighten standards and as they are forced more and more to work on problem credits. It is hard to generate new business when your hands are full with existing issues that must be resolved. We project loan growth for most community banks will average somewhere around 4% for the year, as the full impact of the credit crisis takes hold.

Finally, we don't see big inflows of deposits and project growth will run at about 2% for the year for most community banks. One key driver for softer funding levels is a continued drop from title, escrow and homeowner associations amid more weakening in the real estate sector (this group of depositors was one of the biggest for community banks). On the good news front, common sense is slowly returning to the deposit market, as some of the larger names that were paying ridiculous rates just to survive are clearing out of the way.

The bottom line - community bankers should expect pressure on earrings to continue, higher nonperforming assets, sluggish economic activity, high competition, weak loan growth, listless deposit growth and tepid M&A activity.

While we would all prefer to sleep through 2008 and wake up sometime in 2009, that isn't going to happen. The good news, however, is that community bankers are a tough lot and should not be underestimated. While many are likely to hear the dentist's drill in their ear all year long, those that stay focused on credit quality, liquidity and risk management can also expect to find money under their pillow.

BANK NEWS

M&A

FNB Corp ($590mm, PA) will purchase Iron & Glass Bancorp ($300mm, PA) for $82.93mm, or 2.2x book. This a good example of an average performing bank, being attractive due to their underleveraged deposit base.

Phone Link

Citi is testing a new service that will allow customers to send money from their checking accounts to other bank customers through their mobile phone.

Auto Loans Falter

In the latest sign that the credit crunch is spreading beyond the housing market, auto loan delinquencies have now hit a 10Y high.

Corporate Picture

A new study from rating agency S&P finds 51% of corporate borrowers in the country were rated below investment-grade (BBB), compared to 28% in 1992.