THE BRITISH HAVE COME TO COMMUNITY BANKING

by Steve Brown

When you think of the London Interbank Offered Rate or "LIBOR," you may conjure up images of a proper British gent with an ascot around his neck. That doesn't sound like anything a self-respecting community banker would be caught dead in, so why the hubbub over this index. Why can't we just use Prime for everything in the good old U.S.A.?

To get to the bottom of this, we first need to know what LIBOR is and is not. LIBOR is a daily reference rate, where one bank will lend to another bank in the London wholesale (inter-bank) market.

LIBOR is used to change interest rates on loans (from fixed to floating), set deposit rates and as a reference for currencies trading worldwide. So many global banks now use LIBOR as a reference rate that it has become one of the world's most liquid markets. As such, it has become the basis for most trading. Maturities for LIBOR can be found stretching out as far as 50Ys, with most activity occurring with a maturity of 10Ys or less.

LIBOR caught fire over the past few decades primarily because bankers worldwide needed a common index they could use to transact business 24 hours, 7 days a week. Gone were the days when large banks in the U.S. could work from 9am to 5pm, close up and go home. That was replaced by a global trading book that passed through multiple hands worldwide, on a relentless 24 hour schedule. Starting in New York, traders would work their 9am to 5pm shift. At its conclusion, they would then transfer their existing positions to the next shift, which given the time zone was Asia. The team in Asia would then work their own 9am to 5pm local shift, before passing the trading book along to their counterparts in London. Those traders would then repeat the cycle, before eventually handing the trading book back to their counterparts in New York as they in turn headed for home. This structure is how large global banks trade billions of dollars of securities, currencies, cash, interest rates, loans and much more. It is also why LIBOR has overwhelmed all other indices in use by banks across the world.

For community banks, there is no global book of business to contend with and Prime seems to work just fine. That is largely true; however a problem surfaces because community banks must compete in local markets with large global banks for deposits. Since these large global banks set their daily deposit rates based on LIBOR and they also control most of the deposits in any given U.S. market, community banks that compete are defacto setting their own deposit rates based on LIBOR. This may not be overtly understood or even tracked, but it is factual.

Now that it is understood LIBOR is the baseline for bank deposits in the U.S. as well, it is easy to see why large banks doing business here favor LIBOR on the asset side as well. To avoid mismatching funding costs and lending indices, large banks use LIBOR on both sides of this equation. In so doing, they reduce risk and ensure margins are maintained.

The bottom line is that while community bankers don't have to wear an ascot to work, it is important to know that LIBOR is how deposit rates are set all over the world. As such, LIBOR has become the global proxy for baseline funding costs of large global banks (which is why it is also known as the Eurodollar deposit rate). LIBOR may sound like a very fancy and still unfamiliar term to some, but understanding it as the baseline funding cost for various maturity dates should help. Then, when we think of pricing a loan to a customer, it is easy to understand that if our funding cost is LIBOR and the loan is priced at LIBOR plus 250bp, our net interest margin is 250bp. The good news is that most community banks also fund themselves substantially below LIBOR, so the true net interest margin community banks receive is more like 300bp to 500bp, once that is also taken into account and funding costs are adjusted further.

BANK NEWS

State Street

The bank announced that they underestimated the $625mm previously set aside as damages for pending lawsuits by a whopping $6.9B. The reserve was related to subprime mortgage-backed securities investments that lost money and were made on behalf of pension fund clients.

Integrity Bank

The $1.2B bank in GA becomes the latest to enter into a written agreement with the FRB prohibiting it from paying funds to the holding company for dividends, trust preferred payments or holding company debt.

Student Loans

President Bush signed into law the 2008 Student Loan legislation (HR 5715) that empowers the Dept. of Education to purchase federally guaranteed loans that lenders are unable to securitize. In addition, it also tasks the Dept. of Ed with the allocation of capital down to the state guaranty agency level.

Branching Pullback

A new study by Greenwich Associates highlights a significant disconnect between banks and their business clients. A recent study found the percentage of business customers who rate the importance of their bank's branches as "low" is 70% higher than banks who were asked the same question. Business owners were also 21% more likely to say the branch has become "less important" to them than banks believe it to be.

Remote Capture

Research finds 16% of small business customers are now actively using RDC. AnalystÃ¢Â€Â™s project this number will reach 25% by 2009 and 40% within 2Ys.