FLUSHING HIGHER DEPOSIT RATES

by Steve Brown

Having just redecorated a home bathroom, we decided to "go green" and install one of these low-flow commodes. This was a horrible mistake, as the old, water-guzzling toilet did the job just fine, but we were trying to do our best for the environment. The problem started when we took the porcelain seat back to the Home Depot. There, the sales clerk just laughed and explained that, since the Energy Policy Act of 1992, all toilets use 1.6 gallons per flush instead of the old 3.5 standard. This is ironic, because now everyone in the family uses the old bathroom, defeating the entire purpose of the remodel. In addition, when we have a dinner party, we sometimes lose a guest for hours at a time, because they are too embarrassed to come out (even after their 12th flush). This is hardly the home or environmental improvement that we expected.

Speaking of unexpected consequences, take a look at the deposit market lately. Spreads on CDs compared to Libor, for the first time since March, have been coming down. This is also happening at a time when banks are more desperate than ever to raise funding. What is also interesting is that this has been occurring in both the brokered and more than half of the 136 local deposit markets that we cover. One reason could be consumers are getting smarter about the correlation between banks that are in trouble and banks that pay a high rate on their deposits.

It is interesting to note that this spread tightening development has been exacerbated in certain maturities of the brokered CD market, as spreads/rates have tightened more than most local markets. One reason for this is that with the filing of 2Q Call Reports, more banks are running tight on their capitalization (some are even falling below well-capitalized). While these banks have traditionally sought waivers from the FDIC that were granted locally, the scuttlebutt we hear is that at least in some markets, it appears waivers must get sent back to Washington D.C. for approval. We are still trying to find the person, department or group that approves these waivers, but we can tell you that they must have one of those low-flow toilets, because it is hard to catch them at their desk.

Another change that has taken place in the brokered CD market relates to supply and an increased spectrum of ratings that are now required. In addition to requiring an IDC rating, some CD buyers are now adding Bankrate's proprietary "Safe & Sound" system (that looks at 22 ratios to measure capital, asset quality, profitability and liquidity collectively, "CAEL") and others. The CAEL rating is similar to the CAMELS system, where "1" is good and below "4," results in reduced access to the CD market. In some cases, buyers are using a matrix approach. They require a certain minimum composite rating (using at least 2 different ratings sources).

The end result is that the confluence of events of banks falling below well-capitalized, problems with ratings and CD buyers becoming more stringent on what names they purchase, is leading to fewer high-quality names in the market.

This presents an opportunity for banks that are well-capitalized, have strong ratings and are interested in gathering cheaper deposits. If you are not doing this already, try launching a marketing campaign by playing up your 3rd party ratings. This will target credit sensitive depositors, which may place deposits with your bank at a lower overall cost as a result.

In addition, contact us to learn more about how and where we can position your bank to garner the cheapest cost of funds through brokered CDs. Another thing bankers can do is to take the wholesale rates that we provide and divide them by 1.15 to take into account cannibalization. If the result is lower than local market deposit rates, then your bank may want to consider issuing brokered CDs to protect your core deposit costs. If the result is higher than your local market rates, then issuing retail deposits is most likely a cheaper way to go.

It is ironic that we now have to go out and find a used, "black market" toilet for our new remodel, just like it is ironic that amidst this market turmoil, banks might be able to lower their funding cost by 10bp to 35bps. The result is below-Libor funding in some cases and for some maturities. Current market conditions present a funding opportunity versus Libor for community banks that we have not seen in the last 6 months. If you can use funding and you qualify for brokered CD issuance, let us quote you some rates and help your bank determine a course of action to reduce overall funding costs.

BANK NEWS

Wachovia

The firm revised 2Q losses to $9.1B from $8.9B and will cut 600 more employees than earlier reported. Losses extended from settlement costs related to auction-rate security probes. In addition, Wachovia has confirmed plans to close mortgage offices and eliminate salespeople in 19 states.

Credit Unions

At the end of May, unrealized losses (largely mortgage related) for the 5 largest corporate credit unions amounted to $5.69B (enough to clear out the net worth of each company). Combined, negative equity totaled $2.9B.