HARNESSING THE POWER OF DELEVERAGING

by Steve Brown

It seems as though every time oil prices go above $100 per barrel, everyone gets excited about finding alternative energy sources. No one we know, however, is talking about harnessing the strength and power of lightning. You see, a single lightning strike can carry enough electricity to power 10mm homes for a month. Forget wind, oil, coal and everything else. To truly create energy, all we have to do is figure out how to harness the awesome power of lightning. As you ponder how to finance a loan that could back such an endeavor, we focus on the powerful deleveraging activity that has been striking the industry as of late.

To understand what has been happening, we need to focus on a few key things. First, deleveraging is the act of increasing the amount of capital banks hold relative to credit they will extend. It is best demonstrated in banking when lenders shed loans or take on more equity as a percent of the loan portfolio.

Next, we have little choice as an industry but to deleverage. New capital is practically nonexistent, banks are struggling with loan losses, markets are extremely volatile and regulators are demanding faster action and higher capital levels. One way to see why is to look at the U.S. ratio of total debt issued compared to GDP. The ratio has soared from 160% in 1975 to more than double that (e.g. about 350%) as of the end of 2007. Consumers have borrowed freely, financial companies lent money easily and spending continued. Now the bubble has burst and we find ourselves in a tough situation. All of these issues will push bankers to deleverage their balance sheets - a process that is already beginning to accelerate. As that happens, lending is pulled from the system and the economy slows.

How that occurs is relatively straightforward, but it is worth a discussion. Worried management teams, directors and regulators begin to seek out higher capital ratios. That causes banks to reduce lines of credit or even sell off assets. That activity puts stress on prices. As prices fall, collateral value falls and the spiral continues. As banks deleverage, consumers will have less money to spend, resulting in an economic slowdown.

The silver lining in the clouds for community banks amid all the bad news is that lending spreads are widening at the same time companies that paid some of the highest rates for deposits are going away. As more cash-strapped banks fail (or are sold off under pressure), funding costs should eventually march lower. This is generally a good thing for banks, as it will also eventually help improve industry profitability. More good news for community banks in this environment is that opportunities abound to capture new customers. Pressure everywhere is mounting for banks to take action and cut back on risky or unprofitable clients. As the pushing and shoving toward the exit signs begins, customer self-selection is also underway. Look for banks seeking to preserve capital with little choice but to eventually "fire" some customers.

We have some work to do before the storm clouds part, however, so remain cautious. Credit is tight, property prices are falling, consumers are strained and corporate profits are beginning to soften. If history is any guide, deleveraging will take years to completely run its course. In addition, the extent of the deleveraging already underway will probably result in a deeper recession than many are currently expecting. Looking forward, economic growth should be below trend, unemployment will rise and asset prices will feel the effects of deflation. Sprinkle in a need to restructure balance sheet risk, recapitalize, increase loan loss reserves and it will become normal for banks to project shrinking balance sheets over the next 12 to 24 months. For the next few years, bankers face a period where growth is "out," while deleveraging and survival are "in."

Deleveraging the balance sheet is already underway, but you won't find any banker we know standing outside in the storm with a kite and key anytime soon. Sure it can be scary when lightning strikes, but bankers aren't an easily frightened group.

BANK NEWS

Bailout Bill

The revised Rescue Plan doesn't appear all that favorable for community banks, but we need to do some checking on what this guidance really means for FDIC institutions. We await the next legislative draft due out today that should have more details. The new warrant and compensation provisions may mean that we have spent a lot of energy on a facility that will hardly be used.

Wachovia Merger

Citigroup will acquire Wachovia's banking operations for assumption of their loan portfolio complete with $42B of losses. The FDIC will take on losses above that amount in exchange for $12B of preferred stock. Wachovia will continue to own AG Edwards and Evergreen (mutual funds).

What's In A Name

The acronym "Troubled Asset Relief Plan" is being ditched for the equally unglamorous "Emergency Economic Stabilization Act of 2008." We still like "Cash for Trash."