DO YOU UTILIZE THE GUARANTEE - AN UPDATE

by Steve Brown

For starters, as many of you saw, the deadline for the FDIC Temporary Liquidity Guarantee Program ("TLGP") was extended from 11/12 to 12/5. Banks that do not opt out on or before Dec. 5th will be required to pay the related fees. The other bit of news that hit yesterday was that starting a week from tomorrow, the election form will be available for banks to submit online to FDIConnect. The question is - should you use it?

On October 29th, we wrote a column that recommended that given the current level of rates, a 25bp charge would seem more appropriate to accomplish the stated objectives. Since that time, we have heard that there is little chance the FDIC is going to reduce the 75bp cost of the guarantee. This being the case, we feel the answer is still yes, for the majority of banks.

Which banks should take it boils down to a function of the financial position of the bank, what the bank wants to do with the guarantee and the expectations for the future. For the sake of this analysis, we assume that by the end of 2009, credit spreads return to some semblance of normal and volatility reverts back to the mean. For banks that exceed a 12% annual probability of default (implying a current credit spread of +640bp to Libor), the liquidity guarantee is mandatory in order to maintain access to funding. For banks that have a 3% probability of default or below (less than 5% of community banks, as it implies a credit spread of less than +295bp to Libor), the answer is also simple - don't take it because it is not worth the 75bp. If on the other hand a banks current probability of default is between 3% and 12% (most community banks), the answer is less clear. For reference, the average community bank (as of 2Q) had a probability of default of approximately 9% (implying a credit spread of +490bp). Here, the question boils down to what will the guarantee be used for.

The most obvious application is in Fed Funds. A bank on the upper end of the probability of default spectrum (i.e. those usually having above average credit losses to capital) will most likely find themselves cut off from most non-gov't funding channels. While a bank might be able to solely rely on the FHLB, TAF and Discount Window, they place themselves at the mercy of the regulators and cease to control their own destiny. For banks that already have high levels of non-performing loans (particularly if they are projected to grow) relative to capital (say in excess of 20%) - take the guarantee to maintain liquidity. For others, it becomes really about the future. Here at PCBB/BIG, we are proud of the fact that despite the downturn, our underwriting methodology remains accurate. As such, we continue to approve banks for Fed Funds lines (although a relationship is required). That means that if a bank continues to meet our credit requirements, PCBB will continue to fund banks in the Fed Funds market with or without the guarantee. Of course, not having the guarantee will require more of a premium to compensate for the risk and is dependent on how the market resets following the opt-out deadline. While we are still trying to project what kind of "tiering" will take place in the Fed Funds market, our best guess is that the average premium (the spread between guaranteed banks and non-guaranteed) for the next year will be no less than 35bp. For smaller banks the spread will exceed 100bp, while for others the spread could be less than 10bp (as everyone is just looking for a home for their cash). The takeaway here is that based on Fed Funds alone to maintain credit lines most community banks will have to take the guarantee.

Other reasons to take the guarantee is that depending on the market, banks can issue Guaranteed Liquidity Notes and save about 25bp in funding cost compared to the brokered CD market (this currently works in the 2Y area of the curve at present). Given the potential volatility, this application is only marginally worth the cost of the guarantee, but if a bank finds itself with excess guarantee capacity, please let us know and we can size the market for you.

The other clear reason to take the guarantee is the ability to raise debt via a holding company loan. For banks that don't receive TARP capital or need additional funding, the guarantee is a good use of 75bp. Here, PCBB/BIG can assist, but we have still not received details regarding a proposed structure (most having to do with requirements after the guarantee falls away), so banks will have to stay tuned for more information.

We will close by saying that we still believe that the 75bp is cost prohibitive for many community banks. As such it could have the unintended consequence of causing many banks to opt-out, weakening liquidity at a critical time in the marketplace.

BANK NEWS

Tighter Credit

The latest FRB survey finds 95% of banks tightened credit standards on large and medium-sized businesses; 85% did so for C&I; 60% tightened on credit-card debt; 65% constricted credit for other types of consumer loans and 20% cut credit card limits for prime borrowers.

Better Conditions

Short-term lending rates have fallen back to levels not seen since before Lehman's bankruptcy. Overnight Libor reached its lowest level since 1997, while 3-month Libor dropped to 2.71%.

Auto Softness

A report from Autodata finds automobile sales slipped to a 10.6mm annual rate, the lowest level in 25Ys.

State Pressure

Moody's indicates 27 states are already in a recession and other 14 are very close.