THE BRIGHT SIDE OF THE DOWNTURN

by Steve Brown

To find an uglier industry outlook, we would have to go back to the Great Depression. However, we are a long ways from the Great Depression, as we have a couple of things going for us, not the least of which is a fast acting (although slightly misguided) government. For starters, we don't have a catchy name. Until we brand this downturn as "The Mother of All Depressions" or "The Great Slump," we will always be playing 2nd fiddle to the 30's. The other positive thing is that we lack something that was more plentiful in the 30's - namely, gin. Bankers in the 30's consumed large quantities of gin which made everything worse. Increasing loan loss allowances are bad enough, but try doing that with a hangover after a 3 martini lunch and it is multiple times more painful. It is a little known fact that most New Deal programs only came about as a result of bankers and politicians wanting to go home early to have a little Ã¢Â€Âœhair of the dog.Ã¢Â€Â Our point here is that things aren't as bad as the 30's and we have many things to feel good about.

To prove our point, back in 1930, banks were trading at 50% of their book value. Today, banks are still trading at 125% of their book. While some banks are trading far below these levels, these are the banks that are most likely doomed anyway. That is OK, as we still have more than 8,400 banks. While we will most likely lose up to 10% through failure or merger, this will leave the other 90% stronger and more competitive. As a result, loan spreads will continue to widen and deposit pricing will ease.

The benefit of the shake out will accrue to those remaining banks. National banks will be weaker and many are pulling back from lines of businesses and geography due to liquidity or capital limitations. In down cycles, national banks are quick to abandon non-strategic business lines and non-strategic geographic segments (look no further than the Citibank announcement today). This has already afforded community banks an excellent opportunity to establish new profitable relationships and to secure existing customers. Community banks with less diversification tend to increase relative performance at this time - not necessarily through asset accumulation, but redistribution (replacing less profitable relationships with more profitable clients).

Another reason for a positive outlook is the position of the yield curve and credit spreads. Credit spreads are expanding and are finally affording banks above historical average returns for forecasted risks (even taking into account the volatility around expected default rates in the market today). For the last 5Ys, banks have struggled to earn above 10% risk-adjusted return on capital. On a product or segment basis, this was especially true for higher yielding assets, because those were under-priced relative to their risk (the higher loan rates often did not offset the higher defaults and higher severity of losses). We are now seeing risk-adjusted returns approaching the 20-30% range using projected default rates.

The yield curve is also going to help many banks that know how to capitalize on this opportunity. The yield curve is upwardly sloping and at historical lows. Except for a brief period in the summer of 2003, the yield curve is at an historical all-time low. This is a great position for the average bank that is funding itself short. Now is the perfect time for banks to book long-term, sticky assets. We are witnessing banks locking in loans at margins not seen for the last 7Ys. With rates at historical lows, debt service coverage ratios are strong and portend very profitable returns. Commercial borrowers displaced from their existing banks are now willing to establish sole banking relationships and transfer excess deposits to one lending institution.

What will be a painful intermediate period for some banks will turn into a fruitful longer period for banks that survive. While the industry sentiment is negative, this sentiment is a short-term view. Performance and return must be measured over a longer cycle. As conditions for banks improve, surviving banks will be stronger and more adept. If not, we can always go back to the martinis.

BANK NEWS

TLGP

The FDIC is reportedly considering revising the TLGP program including charging different fees depending on the maturity of the debt guaranteed. The move is required in order to bring the cost of guaranteeing overnight Federal Funds in line with the risk.

Job Losses

Citigroup will reportedly cut 50k employees (on top of the 23k already cut this year). If this occurs, total reductions would equal 20% of the bank's original workforce.

Foreclosure Aid

The FDIC proposed a loan modification program for owner-occupied properties to pay servicers $1K for adjusting loans with the agency sharing up to half the losses in the event of a 2nd default. The FDIC estimates the program would cost $24B and relieve 1.5mm foreclosures. Despite those measures, more than 3mm homes are projected to be in foreclosure by year-end, double that of 2007.