DIFFICULT TIMES

by Steve Brown

You can bet when Chicago politicians think you are too corrupt, - you're too corrupt. As the Illinois legislature moves to impeach the disgustingly brazen Governor Rod Blagojevich, it reminds us of a similar time back in 1958 when political machine head and mayor Richard Daley Sr. first moved political corruption to a higher, that is, lower, art form. That time also holds the dubious distinction of the last time Prime-based loans reset below 4%.

Currently, 21% of banks in this country are unprofitable. After today, many more will be. Unfortunately, this is the day that we have worried about for some time. Over the past year we have written about including floors on floating rate loans, decoupling Prime from an outside index such as the WSJ (and use their own reference rate) and lowering their overhead cost structure. Today, when the Fed most likely may reduce the Fed Funds target rate by 50bp, community bank net interest margins will drop to the low 3.0% range (on par with national banks). The problem is that that comparatively, community banks have a much higher cost structure and generate only a fraction of income through fees. As a result, when Prime resets down from 4.0% to 3.5%, community banks will be in the difficult position of having their cost structure higher than their earning assets for every Prime-based loan (not on a floor) on a risk-adjusted basis. This hasn't happened since 1958 and marks a negative turning point to bank profitability.

Consider that the average community bank has a non-interest expense cost ratio as a percent of earning assets of 3.6% and you can see how banks will be in a net loss position. The average community bank has approximately 62% of their assets tied to Prime and of those, only 16% have at or in-the-money floors. That leaves a scary 46% of assets that will soon cost banks more than they earn.

Assuming we leave risk out of the equation, the average community bank will be taking a full 1% hit to ROE on a go- forward basis because of this cost structure imbalance. For those of you keeping box score at home, that equates to a 4.3% average ROE heading into 2009 (For banks using our BIG Metrics product you can model your own institution and see your exact affects).

The story gets worse when you consider that banks still face a 2.50% cost of funds and are still under-reserved by an estimated 50bp to 300bp (depending on the composition of the loan portfolio). After adjusting for this risk, it means that after today, almost half of community banks will be operating at a break-even proposition. That is a scary thought and begs the question - how can banks survive?

The answer is difficult, as most banks will have to continue to employ a series of tactics, in order to eke out a profit long enough for the credit markets to turn. Banks no longer have the luxury of running 4.0% money market specials and must let any deposit above 2.2% run off. Additionally, banks need to bring the cost of their business platform down to get an efficiency ratio below 60%. Selling branches, increasing outsourcing,reducing unprofitable assets, pricing loans for actual risk and cutting waste are all moves that are now a matter of survival.

Considering the history of Illinois politics and the fact that the last governor of the state was put in jail for exactly the same thing, it always pays to learn from history. Back in 1958, the only thing that kept banks profitable was the fact that deposit rates were controlled by the government and were kept at near-zero. These days, we all need to find ways to reduce the cost structure so we don't repeat the mistakes of the past.

BANK NEWS

Bankruptcies

Business bankruptcy filings rose 61% in 3Q from 3Q 2007. As for Chapter 11, filing jumped over 75%. Filings for the past 12 months have topped over 1mm.

Credit Cards

60-day delinquencies rose to 4.8%, up nearly 25% from August.

Slower Lending

A Nat'l Federation of Independent Business latest finds just 21% of small businesses plan to expand in coming months. That is the lowest level in 30Ys and indicates banks will have less opportunity to lend to these customers.

Municipal Stress

A recent study finds 43 states are facing shortfalls in their budgets that total about 7% of their overall budget. These states will either have to cut spending, use reserves or raise taxes. Higher projected unemployment in coming quarters will only add to the stress. In general, these problems have lowered muni bond prices (and increased yields) by about 9% from the same period last year.