FED MOVES

by Steve Brown

Yesterday, the Federal Reserve surprised many by basically cutting rates to 0%. The actual move took the Fed Funds Target Rate from 100bp to a more aggressive range of 0% to 0.25%. The Fed also dropped the Discount Rate to 0.50% and set the Reserve Rate at 0.25%. In addition to the cuts, the Fed surprised again by committing to a long period of lower rates when it made the statement, "... the Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time."

The FOMC made clear that it thought the economy has further deteriorated, markets are strained and credit remains tight. The Fed further acknowledged that inflationary pressures have diminished appreciably. The important wording inserted this time was the Fed's declaration of its intention to carry out further quantitative easing - particularly through the purchasing of Agency and mortgage-backed securities (which should also help bring down mortgage rates). Given that the Fed has already quantitatively eased and Fed Fund rates have been hovering in the 14bp range, the move was more aggressive than anticipated and served to drive down future expectations of interest rates.

The move has a couple of implications. First, the announcement was innovative and creates a positive psychological effect. It sends the message that the Fed is firmly in charge and is not afraid to remain hyper-aggressive if required. Second, in moving to a bottom range, the Fed basically ended uncertainty over what it would do with rates in the future. Finally, the move was an acknowledgement that given all the liquidity in the market, utilizing a target rate was no longer practical.

The results of the Fed moves have several important ramifications for banks. First, the Fed Funds market will start to revert to a more normalized version with increased liquidity. The resetting of the Reserve Rate down from 1.00% to 0.25% means many banks will have to make an adjustment on their books, as they have over-accrued (at 1.00%) for the last maintenance period. Going forward, banks will look to move money out of the Federal Reserve (earning 0.25% for the next period) and into Fed Funds. Banks that utilize PCBB's Fed Funds pool, for example, earned almost double (more than 50bp) the return last period, compared to banks that left their money in their Fed accounts. Looking forward, we anticipate the future to be much the same.

In terms of loans, while we anticipated banks would lag their Prime rate, Wells Fargo was the first to move to the full 3.25% rate and other major banks capitulated and followed suit. As we wrote yesterday, this will dramatically reduce earnings on those 46% of community bank assets that are tied to Prime and do not have floors. More importantly, this drops most Prime-based loans below a bank's infrastructure cost on a risk-adjusted basis, making them unprofitable without further cost reductions.

From an asset-liability standpoint, the shift down in interest rates shortens duration of most bank assets and liabilities. That makes the balance sheet more sensitive to interest rates. The screwy thing about this is that while this type of shift would normally increase negative convexity, in this market, it will serve to dampen it in the short-run and normalize negative convexity in the long-run. Given how most community banks are structured, next to adding non-interest (or at least below market) balances, the next best move will be to shift to a net borrowed position (utilizing short-term wholesale funds). Banks are encouraged to rerun their asset-liability reports in order to see what the best profit optimizing strategy is given this significant shift and balance sheet construction.

For 2009, banks should expect lower but more stable short-term rates and a flatter yield curve. The average Fed Funds rate for 2009 is expected to be 0.36% (reaching a high of 0.75% in Dec.) while the 5Y Treasury is expected to average 1.57% (and the 5Y FHLB advance is forecasted at 3.64%).

In sum, the Fed moves sent all the right messages to the market when it comes to liquidity and stability, but they also created substantial challenges for community banks.

BANK NEWS

M&A

Legacy Bancorp ($925mm, MA), the holding company of Legacy Banks, has agreed to acquire a branch office from The Bank of Western Massachusetts ($887mm, MA). Legacy is paying a 4% premium on approximately $12mm in deposits.

Budget

The FDIC has decided to set aside $1B to manage further bank failures next year, up from this years $150mm.

FDIC Premiums

The FDIC approved an increase in deposit premiums by 7bp across the schedule for 1Q. This effectively doubles deposit insurance cost for banks.

Goldman Sachs

Closing out the 4Q, Goldman Sachs posted its first public net loss of $2.1B as values dropped in "virtually every asset class." Net revenue was a negative $1.6B.

Commercial Lending

Tight credit markets, rising unemployment, a consumer pull-back and business job cuts are expected to place additional stress on the real estate sector. Retailers, commercial property owners and warehouse centers are expected to see increased bankruptcies in 2009. Bankers are advised to comb through portfolios and consider proactively restructuring loans in order to help borrowers survive (and reduce an upsurge in delinquencies or defaults in coming quarters).