STRATEGICALLY PREPARING FOR DEFLATION

by Steve Brown

Last Friday, we talked about the microeconomic things a bank can do to increase profits. Over the next 2 days, we focus on the macro. We start off with an immediate challenge - Is your bank prepared for recessionary deflation? As demand for goods and services decline, sellers react by cutting prices (in order to attract more demand), thus creating a rare deflationary environment. Last Friday, for example, several major hotel chains dropped their pricing on both current and future room rates. In similar fashion, major department stores continued their post-Christmas sales and offered even deeper discounts. A deflationary environment creates a downward spiral of prices. Demand shifts down, as buyers wait for better deals. While price drops are not widespread enough to result in technical deflation, we are getting close after Friday's ISM Prices Paid report. Regardless, for banks, the impact will be substantial in 2009.

In addition to the normal affects of a recession such as a sharp decline in aggregate demand, less production, higher unemployment and financial stress; the fact that short-term rates are now essentially at zero has serious asset-liability implications for banks. Since, short-term risk-free rates are now constrained (they can't go too much lower), the Fed will be forced to bring down intermediate rates (by essentially capping Treasury and mortgage rates through the purchase of these securities at a certain yield level). This will serve to flatten the curve by bringing down rates in the 2Y to 10Y area. Banks that have key rate duration (also called "partial duration") sensitivity in this range will see further margin compression. For others, the flatter curve will create greater demand for fixed rate loans by borrowers. Banks need to run additional scenarios highlighting this curve flattening to see how liability and asset prices impact earnings and risk.

Speaking of borrowers, the other major implication of a deflationary period is the increased real cost of borrowing. When nominal interest rates are reduced, the real interest rate paid by borrowers equals the expected rate of deflation. Thus, for borrowers of commercial real estate, their cost of borrowing is essentially the cost of the loan plus the forgone loss of purchasing power. In retail lending for example, the cost of deflation has made the real cost of borrowing prohibitive for most geographical areas in the US. The other side of this equation is that banks that take collateral will have to increase underwriting standards just to maintain the same level of expected losses. In periods of deflation, asset prices drop, rendering cash flow from non-property operations relatively more important than real estate collateral. This is why quality C&I loans become more valuable in periods of deflation (absent changes in credit).

For banks that don't increase underwriting standards, expect higher losses (which is why we forecast loan loss reserves will reach an average of 3%). The real increase in the cost of borrowing will lead borrowers to suffer a loss of property cash flow, providing greater incentive to default. This occurred after the Civil War (a fact that caused America's return to the gold standard), after the Great Depression in 1930 to 1933 and most recently occurred in Japan.

In addition to better understanding your bank's asset-liability position, preparing for greater fixed rate loan demand and enhancing loan underwriting, banks can reduce inefficient operating overhead, keeping branch purchases to a minimum (they will be getting cheaper), increasing the use of technology (to lower unit costs) and staying away from commoditized lending lines (such as residential mortgage lending).

Finally, banks need to rethink their pricing strategy on a variety of loan and deposit products in order attract more business. Since both business owners and consumers are more driven by value in a deflationary period, tomorrow, we will highlight some pricing moves that are working for other banks.

BANK NEWS

IndyMac Sold

The FDIC will sell IndyMac for $13.9B to a private equity group led by Dune Capital Management. The FDIC has been looking for a buyer since July, when it took over IndyMac. The deal gives the private equity group 33 branches, $6.5B in deposits, loan and security portfolios valued at about $22.9B and a loan servicing portfolio worth over $175B. In addition, under the deal the buyers agreed to assume the first 20% of losses on certain mortgage loans, with the FDIC taking 80% of losses on the next 10% of bad loans and 95% of loan losses thereafter.

M&A

Premier Financial Bancorp Inc. ($732mm, VA) will buy Abigail Adams National Bancorp Inc. ($436mm, DC) for $10.9mm. Combined, Premier will operate 8 subsidiary banks and service $950mm in deposits.

Regulatory Reminder

A letter from the FDIC, OCC and FRB reminds banks opting for the unlimited coverage of checking deposits with zero interest that they must make record of those deposits exceeding the limit $250k.

State of Crisis

5 governors (NY, NJ, MA, OH and WI) have asked for $1T stimulus from the federal government to aid education, infrastructure and welfare.

Retail Sector

The International Council of Shopping Centers reports the 2008 shopping season was the weakest in 38Ys. Meanwhile, projections indicate a record 200k stores will close in 2009. States considered most vulnerable to a retail recession include AZ, CA, FL, GA, IL, NV and PA.