A BAD INDUSTRY HAIRCUT

by Steve Brown

We don't know about you, but when we get a bad haircut, it usually takes months to grow back out. The shock from friends we run into on the street is also inevitable and unavoidable. On Apr. 27, new collateral valuations become effective for banks that borrow through the FRB Discount Window. Across the board, the amount the FRB will lend is being decreased ("haircuts" are rising), which results in less borrowing capacity for banks.

As a quick reminder, the FRB takes collateral through two methods - either "individually deposited" or "group deposited." Under the group format, collateral values for loans are based on assumptions related to average risk characteristics by type. These are subject to periodic change and the FRB obviously feels bigger haircuts are required right now given ongoing deterioration in the industry and economy.

The haircuts found in the picture above (also available at http://www.frbdiscountwindow.org/announcement090330.cfm?hdrID=21), show a sharp reduction in borrowing capacity for community bankers. In fact, when you compare what you could borrow with the updated value, the average percentage reduction in borrowing capacity for group deposited loans is 20%. It is also worthy of noting that home equity loans took the biggest hit, dropping from 85% of loan value allowed to only 50% (a whopping 41% reduction in borrowing capacity). While we are thankful most community banks don't hold much in home equity loans, the size of the downward shift is shocking.

It is important to note that borrowing capacity for individually deposited loans (pledged on a singular basis) does not change. These are calculated by the FRB one at a time, but in no case will they be below the collateral value of group deposited loans.

For bankers seeking some good news, the FRB also announced it would begin to accept senior unsecured debt securities issued under the FDIC's Temporary Liquidity Guarantee Program (TLGP). These break down by maturity buckets, but basically run from 87% (if the TLGP debt is foreign denominated) to as much as 97% (if TLGP debt has a maturity less than 5Ys and is US dollar denominated). For TLGP issuers of smaller size, where a market price may not be available (community banks) the amount that can be borrowed from the Discount Window is 85% of outstanding balance.

The nasty combination of recent cuts in Fed Funds lines by large correspondent banks, reduced borrowing capacity at the FHLB (also through recently announced changes requiring bigger haircuts and more stock), restrictions on brokered deposit usage and now this action by the FRB, community bankers will be even more strained going forward. As such, look for more community banks to shift to delivery status with the FHLB's, monitor available collateral positions more closely (should keep at least 10% of total assets as a min cushion) and reduce borrowings.

Liquidity pressures just increased sharply for community bankers and as a result, we would expect to see even more regulatory action (the worst will be banks that are already below 10% risk-based capital, which now have virtually no place to go if they were relying on these secured lines for liquidity). Don't forget to update your liquidity contingency plan as well. Now that is what we call a bad haircut for the industry.

BANK NEWS

Mutual CPP

The Treasury released terms and conditions for mutual savings banks with holding companies (only 170 of them) to take TARP capital. Similar in terms as public and private banks, mutual bank CPP applications are due May 7th. The move begs the question - what about the other 75% of mutuals without holding companies?

Branch M&A

In addition to the sale of National City Corp's 58 branches, 3 more branches will be sold to Marquette Savings Bank ($525mm, PA) and one to Farmers National Bank ($373mm, PA). Marquette will take on $95mm in deposits and $41mm in loans for an undisclosed premium. Farmers will assume $90mm in deposits for a 3.4% premium and $35mm in loans, cash and the branch's real estate.

Livelihood Uncertain

Corus Bank ($8.3B, IL) has issued a survival warning following a recent audit. In Feb., the FRB and OCC issued an order for Corus to raise its leverage ratio to 9% and Tier 1 RBC to 12% in 60 days. The bank has said it will not be able to reach the requirement. For the 4Q, the bank reported a $316.7mm loss, with loan loss provisions jumping 10X to $336mm w/ approx. $2B in nonperforming loans.

TALF II

The FRB is reportedly considering offering 5Y loans at higher interest rates in an effort to support the CMBS market. The FRB currently only lends to a maximum of 3Ys.