THE FEAR OF MORE REGULATION

by Steve Brown

Five weeks before the stock market crash of 1929, Albert Wiggin, the then president of Chase, knew his company's stock was about to take a nosedive due to growing non-performing loans. Not wanting to go down with the ship he helped sink, he sold his 42k shares before Chase released their financial statements. Although legal at the time, the massive dumping created a panic which ultimately caused Chase to collapse when they couldn't raise any additional equity. Ironically, it was Wiggin that was the most likely investor in the devalued Chase, as he was sitting on $4mm of profit that he made off his own company's misfortune. As a result of this governance travesty, the SEC was formed in 1934.

After every financial crisis, new regulation comes into existence. Sometimes this regulation is good; sometimes the regulation does more harm than good. Whatever the case, we can tell you that bankers are fearful of more regulation. In fact, in our last national survey, next to falling asset quality, the threat of harmful regulation was the next largest concern. This was so much so that over 600 bankers (86% of those surveyed) mentioned it as their largest long-term fear.

As they say, Congress is only good at fighting the last financial crisis. The markets will always find a way to push the regulatory envelope. If quality mortgages are profitable, then Wall Street will look for bigger bucks in subprime. If interest rate options turn into commodities, the market will expand to credit derivatives. The market will always be more inventive than the regulators (since they have more motivation), so we will always have an issue. This is why we have failed to prevent the last 200 crises going back to the Dutch tulip bulb bubble of the 1700s.

Take the current example of the latest trend in regulatory oversight - we need one big regulator. This is misguided. Will it be cheaper? Yes. Will it be better? Doubtful. Will one big regulator have better judgment than several small regulators? We are skeptical. The OCC has always had almost a vice-like grip on Citigroup, yet we would make the argument that this is the one institution that strayed off the regulatory path the most. Further, adding more regulation is not always good as we can point to several instances in the last week where regulatory action has increased the risk of the institution and has caused more negative earnings volatility.

A macro example of this greater risk is the increase in deposit outflows that has occurred in May to large banks. Comments from exit interviews at some banks of commercial customers relates directly to the disparity of bank treatment. By declaring that the 19 stress tested banks are too big to fail but continuing to close community banks every week, a message is being sent that some banks carry the backing of the Gov't. Some of these "anointed banks," such as Bank of America, are still paying high deposit rates. As a depositor, why wouldn't I want to invest my money at 4% and have a government guarantee? Isn't this the definition of a moral hazard?

Our point for this Friday is not that regulation is bad, only that in the last year the risk from adverse regulatory action has increased. Going forward, this will be most likely be even more of a case. For banks conducting strategic planning sessions, it is important to spend more time this year than in the past analyzing what impact potential regulatory changes could have on your projected earnings. Being governed by a new regulator is just one of the more likely changes. If you are a thrift, you can bet that your regulation will look more like a bank. If you are a large bank, most likely more capital will be required. If you are a community bank, expect more regulation around loan underwriting, reserves, loan concentrations, deposit pricing and reporting. When updating a 3Y plan, expect significant changes that could alter the tactical course of your institution.

BANK NEWS

CU Results

According to the NCUA, in the 1Q loan growth shrank by 0.1%; however, deposits rose by over an annualized 10% and the number of members grew by 0.7%.

Ugly Situation

The Mortgage Bankers Assoc. is reporting that 12% of all households with a mortgage ended 1Q either late on payments or in the foreclosure process. Foreclosures hit a new high during 1Q, rising to 1.37% of all first mortgages (a 27% increase from 4Q), while delinquencies also hit a record high at 9.12% of all loans (up from 7.88%). By state, NV (11.75%), MS (11.7%) and FL (10.67%) had the highest delinquency rates. Meanwhile, AZ, CA, FL and NV accounted for about 46% of all foreclosure starts in the country.

Retail Banking

According to a 2009 JD Power study, consumer loyalty to banks has dropped from 40% in 2007 to 35% this year. Committed customers are not only more apt to recommending a bank to others and purchasing more services, but they also bring in 2 percentage points in deposit growth. Of banks that carry a bigger proportion of committed customers, the difference was largely driven by location and online convenience, fees and transactions. In other surveys, one trend that we are picking up is a growing dissatisfaction from higher fees. Reported problems related to fees are up 25% for 1Q and more than a 30% of accounts that leave the bank to other local competitor site higher fees are the reason.