BANKING ON SWEDEN

by Steve Brown

At the height of strategic planning season, one question we toss out to bank management and directors is what probability to assign the possibility that short-term interest rates will go negative next year. While the resounding consensus is 0%, we think it is a little higher. We are not suggesting that negative rates will happen, but we are suggesting that it is probably worth a couple of extra minutes to contemplate. The question is, if that were to happen what would you do?

Before you think that a -0.25% Fed Funds rate is carries infinitesimally small likelihood of occurrence, consider that the Swedish Central Bank moved its key lending rate into negative territory in July. Sweden was the first country ever to do this and other central banks, such as England's, are taking notice. As with the US, credit in Sweden is extremely tight, banks are undercapitalized and the economy is in the doldrums. Beseeched by deflation, the Swedes came up with the mind-bending paradigm to move rates to sub-zero. If that doesn't make you toss and turn in your Tempur-PedicÃ‚Â® Swedish Sleep System bed, consider that the Deputy Governor of the Swedish Central Bank, Lars Svensson, also worked with Bernanke at Princeton.

Essentially, a negative Fed Funds rate would mean that banks would have to pay the Fed for the privilege of keeping funds short. While this would be an immediate "tax" on liquidity, the result would be that negative rates would strongly encourage banks to increase lending, thereby boosting the economy. Instead of keeping money on reserve at the Fed, banks would be encouraged to put money to work, as the probability of a capital loss is guaranteed keeping money short, while there is only a probability of loss by originating loans. Even if money doesn't flow into loans, larger investment portfolios would serve to bring down intermediate term rates, adding some simulative affect to the economy outside of normal monetary policy.

Will it work? No one knows for sure, but it is interesting that Sweden's currency since the move has been one of the best performing of any of the G10 nations. Banks in the country are starting to make more loans, but it really is too early to tell if it will make a meaningful difference. So far, central banks have not moved to negative rates per se, but have kept most short-term rates at or near zero. That said, Swedish banks still charge an assortment of fees, essentially keeping the net cost of deposits in negative territory (which is not all that different than what is occurring here in the US). As expected, deposit funds have flowed out of banks into equities (their market is up), into gold (a near-term high) and into private vaults.

Will the U.S. move to negative rates? Given that we have many more banks, more liquid financial instruments to invest in and a different tax structure, the move is not likely. In talking to bankers, the most common response would be to move to a net borrowed position and invest in GNMA mortgages. Of course, if we do have to face negative rates, the good news is that our mattresses are bigger than the ones sold at IKEA.

BANK NEWS

Industry Projection

Moody's predicts banks will have to book "substantial additional" loan loss provisions through 2010, putting stress on capital and profitability. Increased provisions drove 44% of all banks to losses in the

2Q.

Construction Delinquency

Analysis based on 2Q data from FDIC and Foresight Analytics finds the 5 cities with the highest percentage of construction loans in delinquency are Seattle (31%), Atlanta (23%), Warren, MI (22%), Phoenix (20%) and Chicago (19%).

Citi

The Treasury started talks with Citi over how to unload the 7.7B Citi shares owned by the Gov't's. The department currently has a 34% stake in the company.

Regulatory Crackdown

A tough internal critique by regulators related to bank failures should have bankers expecting to see crackdowns on lending concentrations, allowance levels compared to peers, allowance methodology, capital levels compared to peers, aggressive loan growth, reliance on volatile funding sources, a stronger regulatory response and higher overall capital requirements.

Wind Down

The FDIC is out for comment (ends 9/25) on whether participants in the debt guarantee program would have to cease issuing debt on 10/31 or whether an additional 6 months should be provided to support banks in need of an emergency guarantee. At the end of July, 94 issuers were using the program for a total of $320B.

Banker Pay

Treasury Secretary Geithner said bankers should be paid in stock tied to long-term performance and subject to claw-back if profits aren't long-lasting.

High End Trouble

According to Zillow.com, the percentage of homes for sale worth $1mm or more has climbed 27.3% from Oct. 2008 thru Jul. 2009.

More Orders

Analysis of public regulatory orders finds 49% more were issued in the 2Q than in the 1Q.