LEARNING FROM LEFTOVERS

by Steve Brown

In addition to old photos of your dad's Studebaker and the nose hair gene, the other thing that gets passed on from generation to generation is the need to keep leftovers. Unless its pizza or Thanksgiving, we are generally opposed to leftovers. It never fails that after dinner when we attempt to throw out the leftover salad, the wife, being driven by ancestral voices inside her head, will insist on keeping everything not already chewed. While she truly believes someone will say, "Honey, do we have any 3-day old wilted lettuce I can eat," the reality is she doesn't take into account "food compression" or the concept that the leftovers will be crowded out by new food coming in, so leftovers rarely get eaten.

What goes on in our refrigerator is important, as it is exactly the same thing that happens to deposits when rate setting. Compression occurs when Bank A understands certain deposit-gathering sensitivities, only to find that other banks follow and move their rates to be close to Bank A's. While Bank A used to gather $90k per month extra of net new deposits for every 1bp increase in rates, they now gather $20k. What ensues is "sensitivity compression" and the result is that all banks around a particular target rate area gather fewer deposits than before. Should this occur, Bank A is left with 3 choices - raise rates to restore sensitivities, drop rates and deal with the run off, or do nothing and live with it. From a financial perspective, usually we advocate the latter, sometimes the 2nd choice and very rarely the 1st choice.

The act of thinking through compression is important, as it should be part of your pricing strategy. Knowing how you will react before an event occurs can make a difference. This is the single largest reason to subscribe to our Liability Coach service, as we can assist with setting both strategy and tactics in order to place you in the best position to lower your cost of funds and decrease interest rate sensitivities.

Our example of compression usually comes into play in a rising rate environment. For example, once Bank A sees forward Libor start to increase (see our chart at the bottom), banks may be smart to move rates up quickly, in order to increase deposits before other banks make a move and compression occurs. For example, if rates are set to rise 50bp, moving deposit rates up 20bp early allows Bank A to capture more deposits before others. If you are going to eat leftovers, it is best to eat them quickly and early before they go south. By the same token, moving rates early is the optimal strategy if you are in need of the largest amount of local deposits and are willing to sacrifice rate.

However, moving rates early has the disadvantage of cannibalizing existing depositors and attracting new, rate sensitive customers. The result is a more rate sensitive deposit base. Using wholesale funds like brokered CDs or FHLB advances to fill funding gaps, while lagging your rates up or not moving them at all is usually the better move.

These strategies are particularly important as bankers prepare to adhere to the FDIC sanctioned rate caps. Recognizing which local banks are above the rate caps is a good start for deposit planning. Assuming most of these higher paying banks will shift rates down, it may be helpful to understand how this systemic movement will affect your rate gathering capabilities over the next 6 months (and also lead to tactics you can employ now to make deposit gathering more efficient).

By looking ahead, forecasting and taking into account compression, deposit gathering and leftovers can be enhanced. We can tell you that, in all probability, the salad the Wife has saved will have an inch of blue fur by the time it is touched again. At which point, she will toss it in the garbage - exactly where we wanted to put it 3-weeks ago.

BANK NEWS

Earnings

Our first look at 3Q earnings will come tomorrow with the release of JP Morgan. On Thursday, Citigroup will release and on Friday BofA will.

Bank Equity

Analysis finds community bank stocks are trading between 50 cents to 82 cents of book as of late.

Tightened Credit

Outstanding loans dropped 19% (annualized) over the 3Q, business loans shrunk by 28% YOY.

Economic Survey

The National Association of Business Economists indicates that while 80% of economists feel the recession has ended and expansion is underway, they also see a slow recovery as unemployment remains high. Other predictions included: GDP will be 2.9% in 2H of 2009 and 3% in 2010; unemployment will rise to 10% by 1Q 2010, before easing back down to 9.5% by the end of the year; home prices will rise 2% in 2010 and inflation will remain subdued.

Funds Flush

The FRB is proposing to tap money market funds to pull out some of the $1T pumped into the economy, either through primary deals or by creating a new facility.

CA Mortgage Laws

A series of new mortgage laws were signed that may have repercussion on the nation. Banning negative amortizing loans, limiting prepay penalties, greater licensing (for appraisers as well), a tighter definition of fraud and deceptive sales practices and greater disclosures are just some of the new changes.