LEGISLATIVE RISK

by Steve Brown

If your risk management process is working, hopefully you are tracking what the potential legislative changes could mean for your bank. That's because there have been few other times in history where legislative action could result in a bank having to change its core business model. Luckily, we still have some nascent faith in the American political machine and believe the process will work to create headlines, but little in the way of material change for community banks. That said, we thought we would handicap a couple of items to make sure the salient points hit your radar screen.

For starters, the talk this morning is over what the financial regulatory reform could mean for large bank credit ratings. Without the belief in Too-Big-To-Fail, look for Moody's and S&P to downgrade US banks. While relooking at ratings, we expect many of the European banks to get downgraded as well, either because of their US business lines or because of European debt holdings. Regardless, the credit premium for short-term borrowings is likely to increase. Libor will rise over the next several months by 10bp to possibly as much as 100bp if the Europeans don't get their act together soon. Since this will place pressure on deposit rates at large financial institutions, look for funding levels at all banks to bounce of their record lows and increase approximately 5 to 25bp.

The Reconciliation Committee for the Senate should be named today, which will be the start of some serious political wrangling. Because of this, expect the Senate version to be the baseline, as more provisions likely get watered down (let's hope).

For starters, the Senate bill contains a limit on bank fees for ATM usage that is ill-conceived. Limit these and many banks will just stop allowing out-of-network ATM transactions. The current legislation allows for no price increases, support of costs or reimbursement for fraud. In short, this provision is more draconian than most utility rate mandates by the Public Utility Commission. That said, some price controls will remain, which will have a negative impact on community bank earnings. While it is unclear exactly what the outcome could be, we think of this in the 10% range in a reduction of next year's debit card fees.

The other major change in the Senate bill will be the Lincoln Amendment that requires banks to stop trading derivatives in the operating company. This provision, if passed, would end up hurting the industry more than it could help. Hedging, particularly in a rising rate environment, is needed. Expect the language forcing derivatives onto exchanges to survive and a potential increase in capital for banks that hold derivatives on their books. Other than that, most all other material provisions will be stripped, once Lincoln wins her fight to get reelected. In addition, we look for an exemption for non-financial firms, as right now the Senate language includes corporations.

Finally, look for the poorly crafted Collins amendment to be obliterated. While this passed unanimously, we suspect that not one Senator actually read or understood the impact. The current provision says banks can't count trust-preferred securities as Tier 1 Capital. If left in, hundreds of banks would need to replace that capital and many would fall below Well-Capitalized. Banks would be forced to shrink, drying up billions in lending and further hammering small businesses. If passed, we predict the Collins amendment alone would cause the demise of 200 to 600 banks.

Most of the other provisions, such as those limiting proprietary trading (Volcker Rule) will be modified, but probably stay largely intact. The Fed will get more power, regulatory bodies will most likely be consolidated, clawback provisions for compensation will remain and more risk will need to be retained for securitizations.

All in all, our take is that things could have been worse, so we look for this to be a slight net plus for community banks. While profits will be reduced in the 5% range (due to higher compliance and capital costs, plus fee limitations); large banks will get hit relatively worse (in the 15% range). In addition, we look for the bill to be reconciled just before the July 4th recess, thereby giving community banks some time to capitalize on marketing.

The irony is that this big financial reform act does very little to solve the actual problems that plagued us during the crisis - such as the lack of transparency, rating agency issues and structural problems with the GSEs. However, if things go right, it will be a relief to put this legislative risk behind us and let Congress focus on some other industry such as big oil.

BANK NEWS

Closed (73YTD)

On Fri the FDIC closed Pinehurst Bank ($61mm, MN) and sold it to Coulee Bank ($197mm, WI). Coulee will receive one branch, all deposits (1.33% premium) and all assets. For more information go here

Fin Reg

Congressional leaders say they expect to have a final reconciled financial reform bill ready for signature by the President within a month.

M&A

The Bank of Princeton ($290mm, NJ) has entered into a deal to purchase MoreBank ($73mm, PA) for approximately $5mm. The combined bank is projected to have $425mm in assets, $370mm in deposits and operate 8 branches.

NCUA

The administration's troubled institution list grew by 8 and another $170mm was added to loss reserves, now totaling $896mm.