ADDING FUEL TO THE FIRE

by Steve Brown

Working at any company has its challenges, as we are sure everyone reading this publication can attest to. Whether it is hitting the monthly numbers, navigating a gargantuan credit crisis, or dealing with a boss or co-worker who is self-centered, rude, unethical or just plain smells bad - working in the banking industry right now is difficult to say the least. As if

that weren't enough, even more fuel has been added to the fire in the form of the most sweeping financial legislation reform the industry has ever seen. Bankers everywhere are carefully reading, analyzing and interpreting the new Frank-Dodd legislation, as they try to figure out its impact on the business.

While much of the law is yet to be interpreted by banking regulators, many new regulations are expected and community bankers will be directly impacted. Costs are certainly going to increase, leverage will continue to come down and management teams will be working hard to try and follow the expected byzantine trail of documentation that is likely to come. As the regulation writing begins in earnest, we have already been inundated with various groups interpreting the impact of components of the law. Much is open still and in the hands of the regulators, so some of this is premature, but it does surface some interesting things community bankers should know.

For instance, while community banks under $10B in size are exempted from primary examination, enforcement and assessments by the Consumer Financial Protection Bureau (CFPB), all banks are subject to its rule-making regardless of size. Additionally, the CFPB is housed within the Fed, but the Fed cannot intervene in enforcement actions or prevent the issuance of rules. For community banks, this means competition and costs around consumer product offerings are certainly going to go up. Whatever consumer business lines your bank has, be prepared to respond with more disclosures, policies, procedures, risk management processes and more transparent costs around products and services delivered to consumers.

The law gives the FDIC broader authority in the liquidation process of any bank. Under the new rules, the FDIC has options that include continuing to run the distressed bank, selling off assets, merging it and repudiating contracts. The FDIC does not need to get any consent from creditors, contract counterparties or shareholders, unlike how things work under the Bankruptcy Code. Banks that get into trouble can expect to see credit lines evaporate quickly (so beef up liquidity and contingency planning) and to have to pay up front for contracted consulting services before work begins.

Under the law, one year after its enactment, banks can begin paying interest on demand deposit accounts. This will allow banks to pay interest on business checking accounts and is likely to raise the cost and interest sensitivity of this form of funding. Expect NIM to shrink over time, as competition drives up funding costs in this area as banks battle to retain small business clients.

We will keep doing our research to keep you informed, as this massive regulatory overhaul works its way through the system. Given there will be some 250 to 350 new regulations released over the next 18 months and as various agencies undertake some 68 studies required under the law, the challenges will continue. As such, we will stand at the ready with our water cannon, in order to assist your team in putting out this regulatory conflagration - just in case the flames threaten to get too high.

BANK NEWS

European Spreads

Concern over Allied Irish Bank is bringing Europe back into the spotlight. Spreads in Greek & European debt are up 17%, back to May levels. Market players are questioning the validity of the Euro credit stress test.

OD Protection

A recent ABA survey shows that 49% of bank customers did not opt out of overdraft protection underscoring the value of the service. That said, a higher than expected amount, 46% did or plan to opt out with the rest undecided.

Cost of Equity

In a situation that shouldn't exist for any long period of time, the difference between equity dividend return and bond yields are now the highest they have been in the last 15Ys. 68 of the S&P 500 companies now pay a return greater than the 3.78% average bond yield. The situation is driven by low rates and improving earnings.

Employment View

A Manpower survey shows Q4 hiring plans are positive, similar to Q3 and significantly above last year at this time.

Economic Growth

Morgan Stanley has followed other major Wall Street firms and cut 1 full percentage point off its GDP projection to a range of 2.0% and 2.5% in the 2H of 2010.

Resedential

Analysis by property research firm REIS finds apartment vacancies have crept down slightly to 7.8% from a 30Y high of 8.0% at the start of the year.

Customer Risk

Studies find 70% of small businesses would fail if they suffered a catastrophic loss of their records.