QUANTITATIVE EASING CONSEQUENCES

by Steve Brown

Studies show about 1% of people will click on an email, even if it is from someone they don't know that says "click here to win some cash." For the scammers that send such things out, that is intended, but for that unfortunate group of people who click, it results in unintended consequences. There are plenty of examples of unintended consequences throughout the banking industry right now, but one that many are now talking about is the potential impact from a second round of quantitative easing (QE2) by the Fed.

Discussion began around this issue in earnest, when bankers read that the FOMC said "The Committee will continue to monitor the economic outlook and financial developments and is prepared to provide additional accommodation if needed to support the economic recovery and to return inflation, over time, to levels consistent with its mandate." Given that short rates are already at or near zero, the only place further accommodation can occur is at the longer-end of the yield curve. To do that, the Fed will do another round of quantitative easing, by purchasing longer maturity Treasuries, which will pull down longer yields. Doing that gives both consumers and businesses an opportunity to refinance their debt, reduce ongoing costs and give a vitamin B shot to a weak economy to help jumpstart it. Since this is strategic planning season, we examine the unintended consequences of this action from a community bank perspective.

For starters, just hinting that this easing will come has pushed longer yields down sharply. The 2Y and 5Y Treasury yields have already reached new lows and the 10Y is darn near there as well. For community banks, that means mortgage backed securities and callable agencies held in investment portfolios will prepay extremely fast. That will hammer yields/returns for instruments purchased at a premium. Look for cashflows to flood in over the next 6 months on these securities, book yields to fall and cash to begin to pile up simply given the increased flow.

Next, expect loans with a coupon of 5% or higher or currently sitting at floors around that level to see a heightened opportunity to refinance into a longer term fixed rate. Medium to large customers will be particularly at risk, as large banks seek to boost loan growth to offset their own flood of prepayments. These banks have already expressed a strategy of expanding the customer base by taking clients from competitors, while cross selling more to existing customers in the current environment.

On the liability side of the ledger, the news is better, but only for those borrowings that are longer in nature. Short rates are already in the basement, so most of what community bankers do on the funding front there will be incremental, require a steady hand and must have a consistent approach to squeeze out much more. On the longer end, this action means community banks will be able to borrow very inexpensively through brokered CDs or FHLB advances, so we expect more activity there as bankers move to refinance their own debt at historically low interest rates. One compounding factor here, however, is that banks will likely look to be measured and tread lightly, given extreme regulatory pressure right now to "stay local" vs. going wholesale.

We will delve further into the concept of both quantitative easing and unintended consequences going on in the industry in a future edition, but for now we leave you with a final thought. No matter how much we try to avoid it, the actions of people and governments almost certainly have ripple effects that are both unanticipated and often unintended.

BANK NEWS

Small Biz Bill

The Bill goes to the House today that would allow the Treasury to provide $30B of Tier 1 capital to community banks to support small business lending. In addition, it would also enhance the SBA's 7(a) program.

Microsoft

The Company placed $4.75B of debt in the market. The amazing part is that the 3Y tranche has a 0.875% coupon on it Ã¢Â€" the lowest 3Y corporate coupon in US history.

Bank Crime

Over the 2Q, the FBI recorded 1,146 incidents of bank crime, a 12% decrease compared to 2Q09. Of these, more than 9 in 10 made off with loot amounting to over $8.4mm, although 21% was later recovered. Fridays were the most popular days for robbery and despite the day of week, occur most commonly between 9am to 11am.

Small Business

A survey by Palo Alto Software finds small businesses that completed business plans were nearly 2x as likely to successfully grow their businesses or obtain loans/capital as those who did not have one. The comparison of those who had a plan versus those who did not finds: 36% got a loan vs. only 18%; 36% got capital vs. 18% and 64% grew their business vs. 43%.

Social Media

According to a report by NetProspex, banking ranks as the 3rd most active industry in social media and also third most active in Twitter-ing, topping the music industry and TV/ Radio (traditional media).