AN OVERFLOWING SINK

by Steve Brown

Think what would happen if you clogged the bathroom sink drain, turned the faucet on full blast and then went on vacation for 36 months. When you returned you would certainly find massive amounts of water damage, warped floor boards and lots of expensive repairs ahead. It has been sort of like that for the banking industry when you consider research that found the 36 month period prior to Oct of this year flooded a full $1 trillion in new deposits into the banking industry. The Fed's loose monetary policy and uncertainty about other markets have driven investors into the safety of an FDIC insured accounts. Funding is easy, deposits are sloshing around everywhere and asset opportunities still remain limited.

As bankers everywhere wait for things to return to normal, it is important that we not lose sight of where we are starting from right now. As we consider the impact of Dodd-Frank and all that it brings, Basel III also looms large for the industry. It sounds like some herb you would sprinkle on spaghetti, but it too is destined to pack a wallop on the industry. That is because Basel III is designed by regulators worldwide to make sure large banks have enough capital to protect depositors when credit conditions inevitably weaken again. In short, that basically means Basel III is a new set of regulation that will require large banks to hold additional capital if they are concentrated in a certain type of loan (say in CRE or other loan classification types) for instance, or if regulators see risks in the overall environment are increasing. This new regulation means banks will certainly be forced to operate with lower leverage, which means banks will be less profitable and dividends will be less consistent going forward (since they can be halted at any time by regulators given a bank's profile or risks). Holding excess capital when times are good will soon become commonplace, so bank management teams and boards of directors will need to adapt and modify strategic plans as necessary for the upcoming 3Y period.

Capital is one thing Basel III will require of bankers throughout the world, but to get back to our flooding example, let's shift to liquidity. Here again, Basel III is additional regulation supported by financial agencies all over the world, that is designed to be sure banks have enough liquidity on hand to deal with unforeseen and unexpected issues when they arise (at least for some proscribed period of time). As such, banks should expect to hold more assets in highly liquid instruments (such as cash or Treasuries); more overall assets in securities (that can be borrowed against) and fewer assets in loans that are leveraged up (probably a 90% LTD ratio, for instance, will be the absolute maximum if you want to avoid additional regulatory scrutiny). The days of easy growth, funded by wholesale sources, has officially come to an end. It will take probably a decade for memories to fade enough where those options may once again come into vogue and growth will be the mainstay of banking. However, we venture to say that as we look back on the past few years and this credit crisis, we think things are fundamentally different now. We almost lost our entire banking system and that is a huge factor that makes us strong as a country. As such, we would bet few in the regulatory world will soon forget the gravity of this situation or allow things to get so out of hand again.

Let's hope the next few years lead us into a strong recovery. As that happens, expect to run a clean bank with more liquidity and capital on hand than when this crisis first began. No one wants to come home to a flooded house, so preparing now will ensure you have a happy planning session and clean pipes.

Related Links:
[FDIC Customer Sweep FAQ]
[Trups: FDIC Supervisory Insights]

BANK NEWS

Customer Sweep

The FDIC addressed some confusion over the future of customer sweep as it relates to FDIC insurance in light of Dodd-Frank compared to the Transaction Account Guarantee Program. When you read it, keep in mind that the guarantee is likely going to change for IOLTA accounts. Also of particular interest is the January notification requirement for different accounts, including sweep.

Trups

The latest FDIC Supervisory Insights has a good refresher on trust preferred securities (both issuing and investing) in light of DFA.

Fannie and Freddie

We keep getting asked about the status of the explicit Gov't guarantee that runs out at the end of 2012. No word yet, but we can tell you negotiations are slower than expected and the odds favor an extension of the guarantee, but at a higher cost that incents the GSEs to bring in more private capital. Look for a decision in January.

Bank Satisfaction

Customer satisfaction edged up in banks by 1.3% in 2010 according to the American Customer Satisfaction Index. The average bank satisfaction score was 76, however, we will quickly add that the average community bank score was 80.

Higher Central Rates

Russia hiked its short-term reference rate by 25bp on the 24th (The first since 2008), and China followed suit on Christmas (the 2nd hike in 3 months). Both countries moved rates in an effort to slow inflation.