THE POTENTIAL LOSS OF HEDGE FLEXIBILITY

by Steve Brown

A number of recent government regulations may have unintended consequences for community banks. The limit on debit card swipe fees banks charge retailers is one such example. The regulation was never intended to not have a negative impact on community banks but unfortunately, the indirect issues of going to a two-tiered pricing system for the networks will likely be an issue in some form nonetheless.

The Dodd-Frank Act (DFA) will deliver many such unintended consequences, unless community bankers step up and demand to be heard. While the ICBA and the ABA are doing a good job with many issues, one issue where we think involvement is lacking is the fact that DFA mandates onerous requirements apply to all lenders that hedge their loan positions. Unless an exemption is granted, the result is that the average community bank will have the same operational and margin requirements as Bank of America or JP Morgan if they ever want to have the flexibility to offer customers fixed rate loans and swap them back to floating. While at first this appears fair, further analysis shows community banks will be highly disadvantaged by the new rules.

Consider that community banks use swaps almost exclusively to mitigate risks that occur from ordinary lending activities. Borrowers are asking for fixed rate loans because interest rates are low and banks prefer floating rate loans because that better matches the funding source. Banks, large and small, respond in the same way that they have for the last 30 years - they use hedges to allow the borrower to pay a fixed rate, while the bank maintains a floating stream of revenue on the loan. In this manner, each group gets what they want, risks are contained and mismatches are avoided.

However, national banks have been using clearing houses to conduct their hedging business for years. Smaller banks have used primarily over-the-counter hedge products which allow greater flexibility and are better tailored for smaller transactions (typically for amortizing loans under $10mm in size). The new requirements under DFA create a change in process for community banks but not for national banks - increasing higher costs for community banks which will ultimately decrease community banks' competitiveness versus the national banks. Ironically, in an attempt to decrease systemic risk and reduce concentrations in banks deemed too big to fail, DFA will actually have the effect of increasing risk.

DFA also mandates higher cost requirements (in capital and liquidity) from community banks. While seemingly applying higher costs to all banks, the law unintentionally advantages a few national banks at the expense of smaller banks. Unlike community banks, national banks have more alternatives to hedge their loans. National banks can manage a matched book and do not need to offset swaps with a clearing house, a futures exchange or by entering into an offsetting swap.

Once again, regulations are being enacted that will result in an increase of concentration of loans in a small number of national banks - not a desired outcome when the stated intention is to decrease systemic risk in the banking system.

There is one glimmer of hope related to this specific proposed provision of DFA. The regulators have asked for comments on whether community banks should have the same exemptions from the added costs and complexity that has been afforded to commercial end users of hedging products. We strongly believe this is a sensible idea and have written our own comment letter highlighting these unintended consequences. Community banks should be treated as commercial end users to help alleviate extra cost and complexity.

For other banks looking to express their view on this issue, you are welcome to join our efforts to help underscore community bank's views on this provision of the DFA. To that end, send us an e-mail and we can provide you with a short and direct template with procedures to submit your own comments.

BANK NEWS

SBLF

Secretary Geithner told Congress distributions of SBLF capital will happen "very soon" and the program has received 869 applications for $11.6B in funding. Treasury is expected to distribute funds by the end of June and a handful of banks have just announced this week that they had been approved.

Slower Economy

The Fed cut its 2011 economic growth forecast less than expected (by about 12.5%) from April's 2.9% projection to 2.7% GDP for the year.

Tax Holiday

Banks should be aware that it appears that the Administration will drop its opposition to the easing of tax rules to encourage companies with overseas profits to return cash to the U.S. This potential amnesty will create a great opportunity for community banks to not only gather deposits from small to large companies, but also generate foreign exchange fees.

It is All Greek

As Greece goes to privatize some of its sovereign real estate holdings in order to raise capital, it finds itself the only country in Europe without a centralized registry of deeds. About 40% of properties are currently in dispute and lack clear title. The Greek 10Y bond yields are about 17%, up from 5.8% at the start of 2010.