BANKS & THE FOMC, BUT NOT THAT KIND OF MODELING

by Steve Brown

Anyone who does analytical modeling can tell you one of the most important things they do and the place they spend the most time is in setting the assumptions. After all, assumptions are the key drivers of any output. Spurred on by growing concerns about the European debt crisis, ongoing weakness in the jobs market and weakness in our economy, the FOMC essentially pushed through a form of quantitative easing yesterday without having to grow the balance sheet. It was creative magic in its simplicity as it pushed bond yields sharply lower and energized the stock market. The key drivers to market activity really boiled down to only 15 simple words that economic conditions "likely warrant exceptionally low levels for the federal funds rate at least through mid-2013." For community bankers, looking to lock in assumption to be used in asset liability, enterprise risk, loan pricing, loan stressing, relationship profitability and deposit rate setting models for at least the next few years we point out the word "likely" and that the Fed will not hesitate to remove the statement at the first sign of serious inflation. That said, the short-term path of rates is at least now more certain.

Before you get too carried away thinking the future is set in stone and your modeling efforts are going to be easy, however, you have to read further in the FOMC text as you consider other takeaways. There you find the FOMC also said they anticipate the unemployment rate will decline only gradually (jobs will be tough to find, businesses will probably only expand slowly; lending will remain tough to originate and prepayments will accelerate as low rates drive businesses to lean toward long-term fixed borrowing over floating rate); downside risks to the economic outlook have increased (this could lead the Fed to take other action that we will talk about in a moment); inflation will settle down over coming quarters (GDP will be low, as consumer spending slows even further); economic growth this year has been considerably slower than expected (the Fed is preparing to take even more action to ease conditions if needed so you should be prepared before it happens as much as possible); and the housing sector remains depressed (get on the stick Congress and start drumming up ideas to take the inventory off the market).

One remaining point we will make this morning relates to future action the FOMC could take. Simply put, the Fed's view of the economy at this point is a gloomy one. That, combined with the dual mandate they carry requires the Fed to seek to foster maximum employment and price stability. That means unless the outlook changes, the FOMC will take further action to try and stimulate the economy. Of those most often discussed in the press, the Fed could start buying bonds again in an effort to drive up the price and push down the yield. They do this to stimulate housing and business loan refinancing activity in order to put more money into the pockets of borrowers that can then be spent on goods and services. The problem with this effort is that it balloons the balance sheet, which is already gigantic, so it is deemed less likely. Another twist on this is to sell short term bonds and buy longer term ones. This pushes up yields with shorter maturity dates and pulls them down on the longer maturities without further expanding the balance sheet. This could be an option, but it depends on what the Fed sees throughout the curve, as each action can have unintended consequences as well. Another potential tool the Fed can use is to cut the excess balance account rate from 0.25%. This would have the effect of forcing banks to put short money to work further out the curve, as the strain on margin simply becomes too much. That in turn would help stimulate the economy if the theory holds. Of all the options listed, this one is probably in the top two, so being prepared is important. We are sure if you asked Tyra Banks, she would say modeling of her sort is not easy. We are also sure that sentiment would be echoed by the quant geek in your bank that handles modeling of the quantitative variety that is toiling away in the corner of your bank. Modeling still isn't easy, but the FOMC announcement at least limited some of the unknown certainty allowing bankers to take more decisive action.

BANK NEWS

M&A

Capital One will acquire HSBC's US credit card business, including its approximately $30B portfolio, for $2.6B or an 8.75% premium to outstanding notional. Cap One expects the acquisition to be accretive in 2013.

Turning In Charter

Main St. Bank ($312mm, TX) announced plans to turn in its state charter, citing the inability to produce an adequate return due to economics and regulatory pressure. Over the last 5Ys the bank has averaged a 2.7% ROE.

BofA

Despite strong corporate desire, BofA bows to regulatory pressure and files a capital plan without a dividend increase in 2011. In other news, BofA agreed to sell its approximately $73B of non-performing home loan portfolio to FNMA for less than 1% of outstanding notional. We also point out that the Bank is trading at 50% of book.

Wells

Unable to generate sufficient loan growth, Wells agreed to buy approximately $1.4B of performing CRE loans in the Northeast from the Bank of Ireland for near par.

Housing Slump

Prices in 20 major US cities have fallen 33% from their July 2006 peak according to S&P/Case-Shiller.