GOOD IDEA OR KNOCKING OVER MORE DOMINOS

by Steve Brown

The "law of unintended consequences" says actions of government always have effects that are unanticipated or unintended. Noted sociologist Robert Merton even went so far as to label instances in which someone wants the intended consequence of an action so much, that he purposefully chooses to ignore any unintended effects the "imperious immediacy of interest." No matter what you call it, the ideas we have heard floating around the press designed to allow people with underwater homes to refinance at current interest rates, is fraught with risk for bankers.

The concept sounds good. It allows people who have been making payments on their homes on time the ability to refinance their loans at much lower interest rates, despite the fact that their home value has dropped significantly. The program would benefit loans guaranteed by FNMA, FHLMC, the VA and FHA. Under the program, debt to income ratios, loan to value and credit would be ignored; as long as the borrower was current for 3 months. This would be a boost to the economy in theory, because it would put money into the pockets of consumers that own homes and help the 11mm or so who have negative equity.

One key problem for banks is that they hold lots and lots of mortgage backed securities (MBS) that produce a return. Given the precipitous drop in interest rates over the past few years, MBS prices have soared to $105 to $108 premiums. When loans that feed those securities refinance or pay off, they do so at $100, so the bank suffers a $5 to $8 immediate hit to performance. All told, about 75% of FNMA and FHLMC mortgages carry interest rates above 5%, so the impact of a major refinancing wave could be substantial. One problem with this is that a mortgage is one person's liability and another's asset, so if one gets more cash from this event, the other must inherently pay, so things balance out. In other words, the gains the homeowner get come at the cost of bondholders.

This could also hurt bank equity. As equity investors see banks taking hits in performance, they could dump bank stocks and reallocate into less risky sectors. This could reduce equity investment at a time banks need it and have a devastating effect on an industry that is just beginning to find its sea legs. The industry is already under strain due to significant legislative and regulatory changes, so this is spooky.

In addition to banks, other stakeholders, such as FNMA and FHLMC, could themselves take a hit of $40B to $60B (which could reverberate with an OTTI impairment for banks); the Fed could see a $4.5B reduction in interest payments on MBS it holds (hitting taxpayers with $600mm in expected losses); REITs could be severely impacted (and their stocks could get dumped, since they borrow money and invest the proceeds in MBS); those who lent money to REITs could be hurt; pension funds, insurance companies, mutual funds and foreign investors would also be at risk. All this would add further uncertainty and risk.

This confluence of unintended consequences would also likely change the future. Investors that have been burned by such an event are likely to demand much higher returns going forward to hold MBS. That could reduce liquidity, decrease lender interest in originating new loans and push up rates for all borrowers (as investors demand higher yield to compensate for increased uncertainty). It could also increase the difficulty of managing refinancing forecasts as part of normal IRR work at banks, so that could further impact bankers.

It remains to be seen whether this will happen, in what form and what the ultimate impact could be. That said, we see lots of dominos in this game and worry the smallest bump of the table could lead to unintended consequences in the banking game.

BANK NEWS

Soft Lending

The Fed's just-released Beige Book showed loan demand by consumers weakened across the country, amid high unemployment and ongoing deleveraging. Meanwhile, the report also noted weaker business loan demand, as customers reduced spending, due to increased risks from Europe and economic weakness in the US.

Earnings

M&T Bank reported 3Q earnings fell due to higher acquisition costs associated with Wilmington Trust (although we think earnings were down anyway). Net income was $164.7mm, down 7%. While interest income did grow 5%, fee income jumped an impressive 27%. Loan provisions declined 38%, also helping earnings. BB&T reported a 74% increase in 3Q earnings to $366mm, as provisions dropped 68%. Total revenues fell 13% due to a drop in interchange revenue. Loans and margins were largely unchanged.

Branches & Mobile

JP Morgan reported its total branches increased to 5,396 as of 3Q, up 4% from the prior year and 1% from 2Q. Meanwhile, JP also reported the number of mobile banking customers grew 58% compared with the prior year and 10% vs. 2Q.

Mortgage Lending

As of 3Q, Wells Fargo surpassed BofA as the nation's largest mortgage lender. Wells now has about 25.7% of the market compared to BofA's 24,6%.

Bank Equity

Research finds that of the 1,200 publically traded banks in the country, over 60% were trading below their tangible book value as of Sep 30.

BRANCHING SHIFT

The CFO of PNC said the soaring popularity of internet and smartphone banking have the bank taking a hard look at consolidating branches in the years ahead. PNC is the 6th largest bank by assets and has 2,469 branches.