CLEANING UP LIQUIDITY AND BANK MANAGEMENT

by Steve Brown

Yesterday, while we sat in the family room trying to decide if it was better to kill time watching the NHL All-Star game or the Pro Bowl, fate stepped in. We got hit with this feeling that something was wrong. It could have been a 6th sense that homeowners develop, but it was more likely the fact that we found a swimming pool in the middle of the family room. Tracing the problem back to underneath the kitchen sink, our genetics took over and we did what all manly men would do - after cleaning up the water and seeing nothing leaking, we hoped the problem would magically go away. This finely honed survival instinct also allowed us to go back to watching football. We bring this homeowner vignette to your attention because we have a similar problem with the global economy. Central banks around the world are leaking money at an unprecedented rate and there is now a pool of liquidity on the floor. Because of collective quantitative easing, the balance sheets of the Fed, ECB, BOE, BOJ, Budesbank and others are all at record levels. The total size of the 8 largest balance sheets have almost tripled in the last 6Ys from $5.4T to more than $15T (and still growing). The result of this build up in central bank reserves is that it artificially lowers rates and makes asset classes like fixed income securities, relatively overvalued. The low rate environment also provides incentives for banks to take on riskier assets in the form of loans. As we look back over the performance of different bank asset classes, we notice a phenomenon that we have never seen before - the total return of various asset classes such as C&I, CRE, credit cards, mortgages, investments and even equities are all highly correlated. This is despite the fact that many classes are largely unrelated. Everything is moving in lockstep right now, as if being managed together. The reason for this unprecedented correlation is that the availability of cheap money is overriding most microeconomic aspects of various industries. For bankers, this presents a huge future risk as you have to ask yourself, "How does this process get reversed?" Central banks have to pull trillions of dollars out of the economy, both in terms of physical money and in terms of leverage. The solution gets more complicated when you consider that central banks have inflated their balance sheets in different ways. Unlike the Fed, the ECB has predominately used repo, which contains an element of credit risk. Thus, a credit shock brought on by rising rates could cause a reversal in leverage much faster than anyone could anticipate. The bottom line for banks is that for 5Y planning purposes, management needs to understand that until a global exit strategy is articulated, volatility will remain high because of leverage. This means risk management becomes more important than ever and model risk (ALM, credit, etc.) also climbs. To that point, bankers need to also understand that credit is being artificially supported right now, thus if given the choice between quality assets at low spreads and riskier assets at wider spreads, the former is preferred but the latter is often chased to support margin. Many asset classes and geographies are performing at above zero return levels only because of this liquidity support. In addition, excess liquidity will keep commodities and equities well supported - asset classes that will also act as bellwethers when this reverses. We will be discussing more risk management strategies relating to this liquidity reversal at our upcoming May EMC Conference. Similar to our kitchen leak, ignoring the issue rarely works. That is one reason why we had to reach back into our testosterone- developed bag of tricks and pull out the duct tape and WD-40. Let's just say for the global economy, we are going to need a lot of this stuff to fix the problem.

BANK NEWS

Closed (7 YTD)

Regulators closed: 1) First Guaranty Bank and Trust Co. of Jacksonville ($378mm, FL) and sold it to CenterState Bank of Florida ($1.9B, FL). CenterState gets 8 branches, all deposits (except brokered) and entered into a loss share on 78% of assets. 2) Tennessee Commerce Bank ($1.2B, TN) and sold it to Republic Bank & Trust Co. ($3.0B, KY). Republic captures 1 branch, all deposits (except brokered) and $204mm in assets (FDIC will retain the rest for later disposition). 3) Patriot Bank ($111mm, MN) and sold it to First Resource Bank ($15mm, MN). First Resource gets 3 branches, all deposits and entered into a loss share on 71% of assets. 4) BankEast ($273mm, TN) and sold it to U.S. Bank ($326B, OH). U.S. Bank captures 10 branches, all deposits and essentially all assets (no loss share).

Purchase

Town and Country Bank ($286mm, IL) will buy a branch in Quincy, IL from Associated ($22B, WI) for an undisclosed sum. Associated had announced late last year that it planned to close 21 branches in total with 3 in IL.

Expanding HAMP

The Obama administration announced it will expand eligibility to borrowers with higher debt loads, extend the program to 2013 and triple incentives it pays banks to reduce loan principal (will pay between 18 cents and 63 cents for every $1 lenders take off principal).

Global Eco Risk

New IMF forecasts indicate "Financial conditions have deteriorated, growth prospects have dimmed, and downside risks have escalated" globally. As such, global GDP was cut from 4.00% to about 3.25%.