THE ISSUES WITH EASING

by Steve Brown

The Fed is doing another round of quantitative easing. This marks the 3rd move down this road, so it is known in financial circles as "QE3." To understand the full impact of this action on community banks, we begin by discussing prior easing moves to help set the context. When the Fed "eases" in this fashion, they buy securities in the open market, reducing supply and decreasing yields. Since the Fed doesn't want to take much risk, they usually buy the safest of securities, such as Treasuries or agency mortgages. The goal in this process is to pull down longer-term yields, by reducing the supply of bonds available. To understand how well this has been working we have to go back to 2008 when the Fed first took action under QE1. This first easing action reached $1.75T over time and it has been effective in pulling down longer-term yields. It has also served to push investors out of safer bond investments (too expensive) and into the stock market. That worked for awhile and in mid-2010, the Fed stepped in and did QE2. This was driven by dissatisfaction with a high unemployment rate and a lack of economic activity. Following this action, the 10Y Treasury yield eventually dipped to record lows in July of this year (1.38%). Since then, while some upward creep has occurred, yields have stayed historically low. Under these programs, for this year alone in fact, the Fed has purchased some $360B in longer dated maturities and now controls about 65% of the total gross issuance of all Treasuries available for these maturities. Now, the Fed is back in the market with its latest program, QE3. Under this program, it plans to buy $40B of agency mortgage securities each month on an open-ended basis until unemployment declines. This has driven down yields in mortgage backed securities (MBS) and driven up prices. All told, this new action and reinvesting existing debt under prior programs means the Fed will be sucking down about 80% of all new issuance from FNMA, FHLMC and GNMA in agency mortgage issuance. That is astounding and the impact on community bankers is profound. Consider the typical community bank securities portfolio makes up about 18% to 20% of assets. Further, by type, community bankers hold huge percentages of MBS, so any action that sharply reduces investment options or yields on MBS isn't good. Consider as well that such actions mean community bankers as an investor group will have fewer, plain-vanilla structures to choose from to generate earnings. That means risk will return. In fact, risk is already returning to the portfolio and balancing it is very important at this juncture. Community bankers are under severe pressure, given the significant cost of additional regulation, extreme competition and the impact of changes on the industry (not to mention a weak lending environment). Now, many have begun moving away from government backed securities toward structure, credit or interest rate risk (to generate a return). Unfortunately, there is no free lunch when yields are stuck at such low levels in the market. When this happens, every 10bp more you try to capture can be an exponentially impactful move in risk, so extreme caution is warranted. When the market moves, riskier assets will be seen for what they are and the impact on capital and earnings could be significant (i.e. Basel III changes alone could hammer capital when rates rise). As if that weren't enough to deal with, a significant problem has arisen for community banks given the Fed's move to prop up the economy and jobs, as it places inordinate pressure on community banks (with a largely margin driven business model). As such, community bankers must understand that the market conditions will only allow for a low yield right now (unless you take on more risk). As you work to refine your business model and wait for economic strength to return (seems 3Ys or so away still) patience will be required. The longer the Fed tries to save the economy and boost employment in this fashion, the more community bankers will have difficulty generating return in the investment portfolio. To be sure, this is one unintended consequence that is not only unfortunate, but impactful.

BANK NEWS

Banks Closed (43 YTD)

Regulators closed First United Bank ($328mm, IL) and sold it to Old Plank Trail Community Bank ($396mm, IL), a subsidiary of Wintrust Financial ($16.8B, IL). Old Plank captures 5 branches, all deposits (0.60% premium) and essentially all of the assets (entered into a loss-share transaction on $172.7mm of assets).

Rare Situation

To satisfy creditors, recapitalize the bank and meet regulatory requirements, Big Sandy Holding (CO) as part of its bankruptcy plan will auction off its subsidiary, Mile High Banks ($840mm, CO). One bidder that has reportedly surfaced has agreed to buy the bank for $5.5mm and pump in $90mm in additional capital, but more are expected.

Muni Bankruptcy

Atwater, CA is expected to vote on Oct. 3 whether or not to file for a fiscal emergency. If they vote yes, they would bypass the mediation process and move toward bankruptcy. Atwater is a 28,000 person community with $95mm in outstanding debt and would become the 4th CA city to declare bankruptcy if they do so.

Flooding Out

If the TAG program is not extended at year-end (insures all noninterest bearing deposits above $250k), community banks should prepare for the $1.6T sitting in noninterest bearing accounts above the $250k insured level to exit to larger competitors (deemed too big to fail) and money market mutual funds.

Settlement

Bank of America agreed to pay $2.43B to investors to close off issues related to a class action lawsuit around its $50B purchase of Merrill Lynch in 2008. Investors had alleged BofA hid problems at Merrill from its own shareholders who voted to approve the transaction.