The Moment We Have All Been Waiting For

by Steve Brown

After months of breathless commentary, market pundits finally got what they were waiting for, an announcement from the Federal Reserve that they will begin tapering quantitative easing (QE3) asset purchases. We find that the 24/7 news cycle sensationalizes almost every subject so this one is no different. Certainly it is important, but the timing of Fed tapering has been the favored topic of the financial talking heads for about 6 months now. It's at least a little bit fun that 75% of economists predicted that the Fed would make no move in Dec and wait until Jan - oops! Perhaps it was a closing joke from FOMC Chair Ben Bernanke who is finishing his term.

The Fed will reduce its purchases of long term assets by $10B per month to $75B. Further reductions will be data dependent and based on continuing improvement in the economy, but it seems likely that the central bank will continue to gradually wind down its economic stimulus program as the economy gains footing. Interest rates should rise in response, at least in the middle to longer term maturities.

The tapering of Fed purchases is important and not just for banks. Consumers will see higher mortgage rates, plus higher auto and student loan rates. Because the Fed has indicated that its target rates are likely to remain low for some time (even after unemployment has reached or gone below 6.5% so long as inflation remains subdued), prime based rates like HELOCs will not rise just yet (or perhaps until 2016).

For their part, banks should see a number of interesting results from the reduction of Fed purchases. Hopes are running high that rising rates will improve net interest margin (NIM) because lending rates should rise. This may happen over time but there are a number of factors that may inhibit this as well. Consider the improvement in NIM is dependent not only on higher lending rates, but also that funding costs will not rise as much or as quickly as lending rates. Higher rates could wake up complacent depositors and make them suddenly become far more interest rate sensitive. That could cause a faster and larger rise in funding costs than expected so bankers will have to be wary.

The other side of the balance sheet, the asset side may even be even more problematic. As noted above, HELOCs and other prime-based loans won't adjust upwards for some time. Meanwhile, fixed income investments in portfolios like callable agencies and MBS will extend in duration at lower rates than the market (leading to losses and hits to capital).

Most of all, this Fed change means borrowers will be very motivated over the near term to refinance and lock in long term fixed rate loans before rates move higher. To stop customers from walking out the door, banks will be pressured to make long-term fixed rate loans - often with maturities well beyond the timeline the FOMC established for raising its target rates.

Given these factors interest rate risk on bank balance sheets will increase. If you are wondering what you can do to manage interest rate risk, consider the options. Large banks make long-term fixed rate loans and then hedge those loans and keep a floating rate instrument on their books. Community banks can do that too through our hedging program designed just for you. This not only helps banks manage their interest rate risk, but also their credit risk. The borrower, your customer, can depend on a fixed payment as the rate is fixed for them. Your bank holds a floating rate asset on its books, which is a defensive position in the face of rising interest rates. Give us a call to learn more about community bank hedging.

BANK NEWS

M&A

First Financial Bank ($6.2B, OH) will acquire First Bexley Bank ($295mm, OH) for $44.5mm in cash and stock.

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Provident Bank ($7.3B, NJ) will acquire Team Capital Bank ($949mm, PA) for $122mm in cash and stock.

M&A

Bank of North Carolina ($3.0B, NC) will buy Harrington Bank ($229mm, NC) for $24.2mm in stock or cash. BNC also said it will acquire Home Savings Bank of Albermarle ($274mm, NC) for $23.7mm in stock or cash.

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BancorpSouth Bank ($12.9B, MS) will acquire GEM Insurance Agencies (TX) for an undisclosed sum.

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Univest Bank and Trust ($2.2B, PA) will acquire investment advisory and wealth management firm Girard Partners (PA) for an undisclosed sum.

M&A

InterBank ($2.1B, OK) will acquire Park Cities Bank ($422mm, TX) for $11.9mm in cash.

Branch Purchase

BB&T will buy 21 branches in TX from Citibank, as it seeks to expand its presence and Citi seeks to manage costs.

Branch Closures

Citibank said it will close 10 branches in PA in 2014.

Branch Purchase

First Community Bank of Western Kentucky (KY) will acquire 3 branches from First Southern National Bank (KY) for an undisclosed sum.

Gift Cards

CEB TowerGroup Research projects sales of gift cards in the US will reach $118B this year, 8% above 2012.

Lawsuit

The NJ Attorney General has accused Credit Suisse of defrauding investors out of $1B by misrepresenting the risk in the residential mortgage securities it sold in 2006 and 2007.

Economic Growth

S&P projects 2014 will see GDP of 2.6%.