Federal Reserve cuts into banks top-line revenue with lowering of rates

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Designed to stop the bleeding by increasing liquidity into the banking system and the economy and reducing borrowing costs, cutting the federal fund rate is reducing the revenue stream of banks.

Since July 1990, the Federal Reserve has changed the federal fund rate 30 times. As of the end of January, the rate is at it's lowest since November 6, 2002 where the rate stood at .75 percent.

The Federal Open Market Committee (FOMA) decided to lower its target for the federal fund rate 75 basis points to 3.5 percent on January 22. On January 30, the FOMA lowered the rate another 50 basic points to 3 percent.

"There is an increasingly insistent drumbeat urging the Fed not only to not impose contractionary policy on a weakening economy, but indeed to get 'ahead of the curve' through further monetary accommodation," said Dallas Federal Reserve president and CEO, Richard Fisher in a recent speech. "In setting broader monetary policy and the Fed funds target rate, the Fed operates under a dual mandate. We are charged by Congress with creating the monetary conditions for sustainable, non-inflationary employment growth. Put more simply, our mandate is to grow employment and to contain inflation. Unstable prices are incompatible with sustainable job growth. Some critics worry that we have forgotten that axiom. We haven't."

According to the Federal Reserve, financial markets remain under considerable stress, and credit has tightened further for some businesses and households. Moreover, recent information indicates a deepening of the housing contraction as well as some softening in labor markets.

The committee expects inflation to moderate in coming quarters, but it will be necessary to continue to monitor inflation developments carefully.
The policy action handed down by the committee should help promote moderate growth over time and to mitigate the risks to economic activity. However, downside risks to growth remain. The committee will continue to assess the effects of financial and other developments on economic prospects and will act in a timely manner as needed to address those risks.

"For any bank that has floating rate loans, that are tied to prime, the rate on those loans goes down immediately," said Phil Dyer, President of LegacyTexas Bank. "It has a significant impact on our revenue. For example, if a bank has $100 million dollars in floating rate loans and it goes down by 1 percent, that is a $1 million dollars a year that comes out of the bank's revenue.

"Most of our loans float with the prime rate and will be going down; However, our deposit costs will be going down as well over time so it evens out in six months or so," said Bud Heflin, president and CEO of Opportunity Bank.

According to Heflin, rate fluctuations are already built into it current strategic plan and unlike many national banks, Opportunity has doubled it assets since its inception in mid 2007.

According to Dyer, LegacyTexas is typical of many banks in that it has many loans tied to prime.

To combat the problem, Dyer explains that there are a number of things that can be done. Creating fixed rate loans are a possibility but not nessasrily in the current market.

“When you are at the bottom of a rate cycle it is a little dangerous to be making fixed rate loans,” Dyer said. Generally speaking, when you are at the bottom of a rate cycle, a bank will make floating rate loans that will go up as the rates go up. When you are at the higher end of the rate cycle you try to make fixed rate loans and those loans will not go down as interest rates decrease in the future.”

Dyer feels positive about fourth quarter results for LegacyTexas.

“We had a good fourth quarter in 2007,” Dyer said “We are feeling the impact right now.”

LegacyTexas, which has been operating under its current name since 1998, has 16 domestic branches throughout both Collin and Tarrant County. On the other hand, Richardson-based Vision Bank – Texas opened its doors in April of 2007 and has issues to deal with that established banks do not.

“While I understand that it is good for capital markets, as a new bank trying to grow, cuts made reduce my top-line revenue by reducing the interest rate that we charge our customers,” said Greg Mulhollen, president and CEO of Vision Bank. “In trying to compete with deposits, I have to drop my deposit pricing as well in order to maintain my margins, but its tougher to attract deposits. That is probably the biggest challenge that I face right now.”
In order to drum up deposits, Mulhollen has been asking shareholders for deposits and actively calling on businesses. In seeking deposits, Vision Bank is implementing a new retail product.

“Previously, we had been strictly commercial,” Mulhollen said. “We have very little, if any, retail or walk-in business. Right now we have to put a retail strategy in place to try to gain some more deposits.”

“We always knew that raising deposits was going to be the biggest challenge but I did not foresee this enormous drop in interest rates.

“We may just rearrange our thinking so that we are not just using core deposits but we are going to fill in with other monies that are out there. If I can go out and borrow very cheaply, there is a federal home loan bank product that is in the mid 2.5 percent range for multiple years. If I can go out and get a big block of that, $5 to $10 million and we can loan it out at 5.5 to 6 percent, that will maintain our margin. It does not create our long-term franchise value by building up core loans and deposits but I think that we can fill that in at a later date with deposits. I just don’t want to turn off the lending tap right now.”

Because Vision Bank just started in April, it has a very strong loan portfolio and sees no problem associated with that in the future

“We feel that it gives us a leg up on the competition where the big banks jerk back like they normally do and tighten up lending standards. I don’t think that we are going to have to be in that position,” Mulhollen said.

For national banks, the bleeding is ongoing

National banks across the country have reported substantial losses for the fourth quarter of 2007. With the reported losses, financial institutions can only be optimistic about 2008.

“Even given that environment, we certainly are not pleased with our performance. However, we are cautiously optimistic about 2008, though we believe economic growth will be anemic, at best in the first half,” said Kenneth D. Lewis, chairman and CEO of Bank of America.

Bank of America Corporation reported full-year 2007 net income declined 29 percent to $14.98 billion from $21.13 billion a year earlier.

“Our fourth quarter results were severely impacted by ongoing dislocations in capital markets and the slowing economy,” Lewis said.
Bank of America attributes trading account losses of $5.44 billion, compared with profits of $460 million a year earlier, were driven by write-downs of collateralized debt obligations (CDOs) and weaker trading results.
“The losses being reported by some large banks largely reflect losses in CDO’s (collateralized debt obligations). Most small banks, including ours, never bought any of these,” Heflin said.

For Bank of America, CDO-related write-downs totaled $5.28 billion, reflecting the impaired value of the underlying assets based on expected credit losses, the of demand in the marketplace and the impact of credit rating agency downgrades of the securities. The write-down reduced trading profits by about $4.5 billion and other income by about $750 million.

Comerica reported a net income for the forth quarter of 2007 of $119 million compared to $299 million reported for the same period of 2006. That is a reported loss of $180 million.

“2007 was a challenging year for the banking industry, including Comerica,” said Ralph W. Babb Jr., chairman and CEO. “While we continued to execute our strategy, reflected by strong loan growth, particularly in our high growth markets, challenges in the residential real estate development portfolio affected our performance. Our fourth quarter earnings were largely impacted by an increase in the provision for loan losses and a decline in the net interest margin, driven in part by a decision to increase the securities portfolio and a competitive funding environment. Our fourth quarter expenses were impacted by a $13 million charge related to Visa and $2 million of moving costs related to our previously announced headquarters relocation.

“We opened 30 new banking centers in 2007, 28 of them in our high-growth markets of Texas, California and Arizona. We also relocated our corporate headquarters from Detroit to Dallas, positioning our company in a more central location with greater accessibility to all of our markets. Our capital position remains solid and provides us with a cushion to whether continued challenges in the economic environment and the flexibility to continue to invest in our growth markets.”