

Special Report

The Fed pulls out all stops: Impact on banks?

By

Dr. Edmond Seifried

Executive Director of the Affiliation Programs

Fed takes rates to zero and shifts targets

On December 16, 2008 The Federal Open Market Committee (FOMC) made history. The committee decided to change its long-standing policy of setting a specific interest rate target to setting a target range for the federal funds rate. The rate was lowered from a specific target of 1.00% to a target range of 0 to 1/4 percent. An interest rate level that approaches zero resembles the oft-criticized level achieved by the Bank of Japan in the past decade. We believe the fact that the policy change from a specific target to that of a target range is not nearly as important as the current level of interest rates. By lowering rates to zero, the Fed signals that the current economic crisis is indeed serious and worthy of taking extraordinary measures to prevent additional economic hardships. In fact, in an effort to deflect the obvious criticism that the Fed is now out of ammunition with interest rates at zero, the FOMC reminded us that it has additional weapons at its disposal when it noted, "The Federal Reserve will employ all available tools to promote the resumption of sustainable economic growth and to preserve price stability. In particular, the Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time. The focus of the Committee's policy going forward will be to support the functioning of financial markets and stimulate the economy through open market operations and other measures that sustain the size of the Federal Reserve's balance sheet at a high level." The FOMC dodged the critic's bullet that these rate cuts and other announced measures will lead to more inflation, or at least add to inflationary expectations, by noting, "meanwhile, inflationary pressures have diminished appreciably. In light of the declines in

the prices of energy and other commodities and the weaker prospects for economic activity, the Committee expects inflation to moderate further in coming quarters."

FOMC reacts to credit crunch and housing slump with new measures

The FOMC is clearly worried about declining economic conditions and weak labor markets. Plus, recent economic data releases indicate that consumer spending, business investment, and industrial production and capacity utilization levels have dropped. They also admitted that financial markets are nervous and credit conditions are tightening. The worst news of all was that U.S. housing starts continue to shrink. November 2008 housing starts fell to 0.625 million units from a revised 0.771 million units in October. The November rate is one of the lowest in the last quarter of a century and appears puny when compared to the 2.069 million units constructed in the boom year of 2004. This twin development of a weakening housing sector and tighter credit conditions prompted the Fed to announce new balance sheet busting programs that will provide additional liquidity to the debt markets. The FOMC announced, "...over the next few quarters the Federal Reserve will purchase large quantities of agency debt and mortgage-backed securities to provide support to the mortgage and housing markets, and it stands ready to expand its purchases of agency debt and mortgage-backed securities as conditions warrant. The Committee is also evaluating the potential benefits of purchasing longer-term Treasury securities. Early next year, the Federal Reserve will also implement the Term Asset-Backed Securities Loan Facility to facilitate the extension of credit to households and small businesses. The

Federal Reserve will continue to consider ways of using its balance sheet to further support credit markets and economic activity.” However, while the policies noted above may indeed help the financial sector’s liquidity crisis, and ultimately improve the rate of overall economic growth in the long run, the collateral consequences of these measures are sure to negatively impact community banking economic performance in the near term.

The impact on bank performance

While we tend to agree that these troubled economic times require unconventional remedies, it is worrisome that the banking industry might bear much of the burden from these policy initiatives. To the extent that lower interest rates and additional liquidity will lead to the further stabilization of the credit markets, especially the consumer credit markets, the new FOMC policies will have a positive impact on banking. If these policy changes shorten the length of the recession and/or the depth of the current economic slowdown, we should see both higher levels of lending activity and fewer non-performing loans going forward. However, one negative result of these new policies on the banking

sector seems unavoidable, and we suggest bankers move swiftly to try to counteract the impact. It seems very likely that the increase in government purchases in mortgage-backed securities and longer-term U.S. treasuries proposed by the FOMC at the December 16, 2008 meeting will significantly lower long term interest rates. This will lead to a sudden and sharp wave of consumer refinancing of mortgages and other loans which will tend to reduce margins. Furthermore, a refinancing wave that is unanticipated tends to lead to shorter durations on mortgage-backed investments. Banks will find themselves with assets that may rise in value in the short-run, but will be quickly liquidated as consumers begin to prepay mortgages. This consumer-embedded option has been one of the long-standing risks of holding such investments. Now, as banks receive payoffs associated with the early pre-payments they face reinvestment yields that will be surprisingly low. The combination of these events will quickly put monthly budgets out of plan, and have us scrambling for new sources of revenues and/or more efficient operations.

Dr. Edmond J. Seifried

Executive Director – Affiliation Programs
eseifried@smslp.com

Dr. Seifried served as Professor of Economics and Business at Lafayette College in Easton, Pennsylvania for over 25 years and is currently Executive Director of the Sheshunoff Affiliation Programs. In addition, Dr. Seifried is the Chief Economist for m.rae resources Inc, a community bank investment firm. He received his doctorate in economics and business from West Virginia University.

Dr. Seifried serves as the dean of the Virginia and West Virginia Banking Schools and is a faculty member of numerous banking schools including: Stonier Graduate School of Banking, and the Graduate School of Retail Bank Management. Dr. Seifried is a consultant to the banking industry, and is well known as a speaker at bank customer events and as a strategic planner.

