A One, Two Punch
Mardjokic.com
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First I'd like to apologize for missing my last entry; September was a busy month, but thankfully I found some time today.

A copy of this article is available in PDF format here.

So what can I say: I just cannot say enough about banks. In July I spoke about what additional regulation and capital requirements would mean for banks. Today, in the face of a seemingly imminent European meltdown, many are being asked to do precisely that.

But the equity markets are closed for new issuance so raising additional capital means taking down leverage and decreasing the amount of loans on their books. This of course exacerbates the problems in the real economy as struggling borrowers cannot refinance and new borrowers find there is less credit to go around. This is the situation in Europe.

For the US, banks are facing a whole new breed of problems. Operation Twist is a done deal. The Fed is increasing the average duration of its SOMA portfolio which has flattened the yield curve and impacted the outlook for banks in a very material way.

Coincidentally, and I'd say rather ironically, the Frank Dodd Act and Volker Rules have forced many banks back into traditional lending where interest margins are key. Banks make money by borrowing short and lending long. The spread between their cost of funds and the yield on their loan book is their profit, their interest margin. When you play with the shape of the yield curve, you play with the banks' money.

I should probably also clarify what I mean by "cost of funds". I use it rather loosely. It's not just their borrowing costs (deposits, CD's, LIBOR rates); it's that plus their cost of doing business. When they make a loan, think about how many people they have to employ: a loan officer, an underwriter, a lawyer, and a whole team of Committees and analysts that make a loan book work.

But Operation Twist has effectively lowered what they are able to charge customers on the back end so they are now economically less incentivized to lend in the first place. The end result is the same in the US as it is in Europe albeit from a different catalyst.

The kicker to this story is the fact that banks now have to make a decision about where to put their money. What will produce the best return on their capital? Some now believe that is in the Treasury market. However paltry nominal yields might seem today, the cost of 'doing business' in the Treasury market is minimal: a couple of basis points at best. So when you compare the

interest margins on originating a loan vs. buying a Treasury note, it might not be obvious which is going to return more in the long run. Throw into the pot, the added benefit of having to carry no capital against Treasury holdings and the asset class (at least to banks) starts to look very attractive.

Yet the purpose of Operation Twist was to push investors out of Treasuries and not keep them in. I think academically Operation Twist was the right thing to do, but practically, exactly opposite. Combined with the refocus of many banks on 'traditional' bank operations and we have a perfect storm of legislative and monetary policy that puts a floor on Treasury prices and a cap on available credit. It ironic to me as it seems like the left hand does not know what the right hand is doing, but somehow the Fed and regulators were able to come up with a lethal Ali-style one, two punch!