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A Stationary Front in 2007?

By Sarwar A. Kashmeri

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This has not been an easy year for community banks, not just in the Upper Valley, but around the country. The twin culprits have been the steady drumbeat of rising interest rates, which has made it hard for banks to attract low-interest deposits from their customers, deposits that the banks can then lend out at higher rates.

The “inverted yield curve,” which means that long-term interest rates are lower than short-term rates, limits the interest rates banks can charge for their loans. Because the profit from procuring cheap deposits and making expensive loans (“net interest margin” in bank-speak) is a significant part of any community bank's business, it made for a very tough 2006.

Community banks are the lifeblood of economies like that of the Upper Valley. As we begin the final quarter of the year, these banks are beginning to work through their budget cycles and business plans for next year.

So what are their crystal balls telling them?

“The inverted yield curve has put a real squeeze on us,” Stephen Christy, president and CEO of the Lebanon-based Mascoma Savings Bank told me. “What we are paying to borrow money from our depositors has gone up, while our ability to charge a higher rate for the loans has not, and I suspect we will stay in this environment for some time.”

This thought is echoed by Kathy Underwood, president and CEO of the Hanover-based Ledyard National Bank, and Charles Petersen, president of First Community Bank in Woodstock.

“The anticipation is that with net interest margins there is no relief in sight,” Underwood said. She expects the yield curve to stay flat or inverted, resulting in another challenging year for banks. “We have seen another quarter percent deterioration in our net interest income in the last few months,” Petersen added. “The longer the inverted yield curve remains, the more problems there will be.”

With the relentless pressure on the interest income side of their business, the area's banks continue to think of ways to grow the non-interest, or fee-based, component of their revenue base. But this is easier said than done.

Over the last decade, the country's top 50 banks (as measured by asset size) increased the fee-based component of their business by 10 percent as they began offering a variety of financial products -- from insurance to retirement advice and portfolio management. But making this transition is a challenge for Upper Valley's community banks.

Christie, I suspect, spoke for most of his colleagues when he said, “We are always thinking along these lines, but for smaller community banks it is hard. It takes capital and a reasonably sized market.”

Ledyard is in a more fortunate position because it already has a successful trust and investment department. “We will be putting more emphasis on the investment and trust department because that is the fastest growing part of our business right now,” Underwood said.

Christy compares today's economic environment to a weather front that has become stationary. “Not that the weather is pouring all of the time. In fact, the sun peeks out once in a while. But there is nothing on either side of the front, no economic stimulus one way or another, to cause things to go up or down.”

There is even a sneaking suspicion among bankers that, with globalization and the interconnection of the world's capital and money markets, the models that have historically guided the banking business may have changed. For example, it is accepted orthodoxy that an inverted yield curve that sticks around is the harbinger of a recession. “Yet, this environment has been with us for over a year,” Christie said, “and there is no evidence till now, locally or nationally, of a recession.”

I thought about this changed model theory three weeks ago when Amaranth Advisors, a Greenwich, Conn.-based energy hedge fund, misjudged its bets and wiped out $5 billion -- half of is asset base -- in one week.

A decade ago, a hit of this size in the financial markets would have caused real pain. In today's markets it wasn't even noticed. The economy -- and, apparently the fund’s investors -- yawned and moved on.

What advice would the bankers I spoke to offer area businesses that are making plans to face 2007?

“I am feeling more sunny than rainy now,” Petersen told me “I personally believe short-term rates will fall next year based on my bank's experience in the last 60 days.” As for long term rates, 10-year treasury rates are about the lowest they've been, “so if I were a businessman looking at equipment or real estate financing, I’d go for fixed rates of at least five years or more.”

Underwood, on the other hand, senses a very cautious environment. She would advise business people to watch consumer spending as a beacon for where the economy is headed. “In the last few years, consumers have kept the economy afloat by using their home's equity as an ATM machine to spend on vacations, expensive purchases, and so on. With changes in the housing market, increases in oil prices and other expenses, might this spending soon come to and end? So consumer spending is something I'd watch as a guide to the economy’s direction,” she said.

“Use caution and be prudent,” Christie advised. “I think there are a lot of strengths remaining in the economy. We have seen oil prices dip, whether it is sustainable I don't know, but that's put more money into people’s pockets. So build for the future and build on quality and you will be fine.”

Banks, Underwood reminded me, are a reflection of the community. That made Christie's parting words quite meaningful. “You won't get much gloom and doom from me!” he said.

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Sarwar A. Kashmeri of Reading, Vt., advises corporations on communications and marketing strategy and is a fellow of the Foreign Policy Association. This twice-monthly column explores the Upper Valley's “business climate,” focusing on the issues and conditions affecting the region's economic health. Kashmeri can be reached at skashmeri@aol.com.

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