

Financial Managers

update

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Bottom-line challenges

Balance sheet strategies must overcome many obstacles

Many institutions will find it difficult to obtain meaningful earnings momentum with any degree of speed in the near future, due to obstacles presented by a number of serious bottom-line challenges, an industry strategist warns.

It's essential that CFOs and others carefully assess the effectiveness of available strategies for return on equity (ROE) and margins, given these factors.

"I think earnings are going to be stagnant for many institutions for a while," says Matt Pieniazek, president, Darling Consulting Group, Newburyport, Mass.

As the economy improves, institutions are likely to be very competitive, and bankers may have "short memories" about the economic downturn. As a result, they could "get aggressive on their (loan) pricing" again, Pieniazek said.

Credit spreads

Such a tendency could lead to declining credit spreads, similar to three years ago when institutions were "beating each other up for growth" by making irrational pricing decisions, he cautioned. "They were not adequately pricing for risk."

At the time, this was mainly due to intense competition and an assumption that market conditions would remain favorable. Since the downturn, however, loan pricing has become more rational and the spreads being charged for loans have "widened out substantially," he noted. But the problem is that if "memories are short," there likely

will be a tendency to revert to such irrational pricing.

Another significant challenge will be heightened competition for deposits during the next cycle. A major reason will be much more competition from "the new de novo" institutions—the large, former investment banking firms such as Goldman Sachs and Smith Barney, which are now operating under bank charters and competing for deposits, Pieniazek said.

He explained these firms will need to pursue deposits aggressively, because most of their funding previously was done in the repo markets, which have "blown up" and will be slow to re-materialize. "As a result, a lot more of these larger institutions will be competing for deposits, and so that's going to have a tendency to increase bank cost of funds," he said.

Margin pressures

The concern is that with such an increased cost of funds and reduced spreads on credit, there is likely to be significant downward pressure on margins, he added.

In addition, the cost of doing business is going to increase, due to significant, elevated costs associated with regulation, supervision, and compliance. "All of those costs act as a regressive tax for smaller institutions," he said. The overall impact will be much more penal for smaller institutions than large banks as a drag on net income.

Significantly, Pieniazek predicted

that the regulatory arena is also likely to require higher capital requirements going forward, and in many cases regulators are already mandating this. "While it's not always formal, it is absolutely clear in their actions in the field that there is a clear migration in the regulatory arena for requiring higher capital ratios," he said.

He cited increasing anecdotal evidence of regulators imposing the maintenance of arbitrarily high capital ratios on institutions. Such directives are coming in the form of both written agreements and "strong verbal recommendations" from examiners.

While a "well capitalized" designation is ordinarily defined as capital levels exceeding 5% leverage capital and 10% total risk-based capital, there have been many instances in which institutions have been told they would be expected to maintain 10% leverage ratios and 12% to 14% total risk-based capital, he said. "What I am witnessing firsthand in the marketplace is that the new norm seems to be gravitating more towards 8% to 10% leverage requirements and 12% to 14% total risk-based requirements."

The impact of all these factors on earnings and expenses "does not bode well" for the outlook for industry ROE trends, he added.

Unfortunately, if those challenges weren't enough, the situation will be further exacerbated for institutions that have exposures to rising interest rates.

“And rising rates will put margin pressure on many institutions,” he pointed out. “Too many institutions have far greater exposure to rising rates than they probably are aware of, due to inaccuracies in their assessment of interest rate risk.”

He said that many smaller institutions are not currently following some of the requirements put forth in recent IRR guidance. For example, many are not conducting five-year IRR simulations, as recommended, and many rate-shock scenarios frequently don't include scenario changes advised by regulators, such as non-parallel yield curve shifts.

On the other hand, if one assumes that an institution with IRR exposure does comply with the guidance, this begs the question of what strategy an institution can implement, going forward. Typically, there are two basic choices—either shorten the life of the re-pricing cash-flow characteristics of assets, or lengthen the duration of liabilities so that they re-price less frequently, he said.

“But the dilemma is that if you have meaningful exposure to rising rates, you can't possibly sufficiently influence that customer (deposit) behavior and reduce your exposure,” he said. For example, institutions can try all they want, but will not be able to get consumers in this environment to buy lots of five-year CDs. As consumers today are worried about their own personal balance sheets, their depository interests are “the complete opposite of the bank's interests,” he explained.

While an institution wants to lengthen its liabilities, consumers want to shorten them. And similarly, while the institution wants to shorten its assets, consumers and businesses want to lengthen them.

Various options

Given the interwoven nature of the impacts from all of the above factors, Pieniazek assessed the various available balance-sheet options that institutions

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might consider, and evaluated each.

First, institutions cannot really sell their assets in today's environment, because “there's no market for selling whole loans.” So the option of selling loans and reinvesting the money short is not real.

A second alternative might be to extend borrowings, which would be nice—except that most institutions have been paying down borrowings and building liquidity. “Most banks with lots of exposure to rising rates don't have the meaningful capacity to extend out on the curve,” he added.

A third option is to go after wholesale funding, and “borrow money out long,” he said. Then the institution can utilize the longer term funding by either investing it short term, or in floating-rate instruments.

Finally, another possible strategy is to hedge the institution's IRR exposure with derivatives, utilizing interest-rate swaps and caps. (See *FMU*, Jan. 26,

2010, for details on this strategy.)

Of the various strategic options, the latter two are the most viable in today's environment: wholesale funding and hedging.

However, the “Catch 22” for institutions is that regulators in the field are generally “quite negative” regarding the use of either of these options. As a result, many institutions and their boards are “just not willing to go there,” he said.

“In this environment especially, institutions are going out of their way to avoid regulatory criticism rather than invite it,” he noted.

In addition, even if unrestrained by regulatory concerns, many smaller institutions and their boards typically are reluctant to take advantage of these prudent hedging vehicles, because of complex accounting requirements. However, for most institutions, the only meaningful way that they can reduce interest rate risk—because most institutions have materially reduced their wholesale borrowing positions—is to hedge the cost of their deposits, he said.

Given the bottom-line challenges today, Pieniazek stressed that institutions need to consider pursuing these workable options in spite of regulatory skepticism. Management teams and boards must “take ownership” for learning how to use both options.

“Institutions that do so find that they are able to manage the accounting and regulatory elements, as opposed to being managed by them,” he said.

Just be sure, he added, that you document your processes, procedures and discussions in writing to show the regulators that you are following a well thought out strategy. **FMU**