

Financial Managers update

A publication of the Financial Managers Society

Bottom-line challenges

A 'perfect storm' of pressures

Institutions must find balance-sheet strategies that more effectively address a confluence of pressures now weighing on bottom lines, if they are to survive and thrive in the foreseeable future, an industry strategist warns.

The convergence of pressures, which tend to aggravate each other, is almost like a “perfect storm,” presenting an extremely formidable environment in which institutions must operate.

“There are going to be survivors and a number of banks that, quite frankly, don’t survive—it’s inevitable, unfortunately,” says strategist Frank Farone, managing director, Darling Consulting Group, Newburyport, Mass. “I think you’re going to see accelerated consolidation in 2011 and 2012.”

Farone offered a diagnosis of the pressures now facing community institutions and also presented a number of practical strategies to consider.

Serious pressures that must be addressed include:

- Very low interest rates with no end in sight
- Weak loan demand
- Increasing costs
- Margin compression
- Irrational deposit pricing
- Fierce regulatory scrutiny

In assessing the interest rate environment, Farone said it looks like the benchmark federal funds

rate will stay low for the foreseeable future, “almost as far as the eye can see.”

Significantly, some institutions are currently sitting on cash, and it’s “burning a hole in their pocket,” he pointed out. “They don’t like the yields out there in the securities market, and so they’re sitting around like lions in the pumpkin patch, waiting for the ‘great pumpkin’ to arrive.”

But the strategy of just sitting on cash can be a mistake, because every day that goes by with cash in Fed funds at less than 25 basis points “gets to be pretty expensive,” he said.

“As low as these rates are, I can’t afford to do nothing and wait—I’ve got to do something,” he added. “We’ve seen a number of banks shifting into loans from investments, when they can, even at this low point in the rate cycle—it’s almost like they’re crying: ‘Uncle!’”

Secondly, another major problem is that loan demand continues to be “slow to non-existent” for most institutions, he noted. “Loan volumes haven’t grown for over two years.”

“In the current rate cycle, rates have come down so far so fast over the last several years that a lot of loans on the books continue to re-price downward,” Farone said.

He explained that today there are basically two types of borrowers— those that want to go

shorter, and those wanting to go out as long as they can. For example, on the residential side, more than 90% of mortgage originations today are refinancing, and many of those borrowers are going shorter, meaning that such loans will be on the books for a shorter period of time and at significantly lower rates.

Alternatively, other borrowers want to go out longer, seeking 30-year fixed-rate mortgages, now around 4% to 4.13%, regardless of whether they had an ARM or fixed-rate mortgage in the past.

“It’s nearly impossible to get anybody to take an adjustable rate mortgage at today’s low interest rates,” Farone explained. “So what’s happening is that IRR is increasing for most institutions.”

In addition, irrational pricing of loans has begun to resurface again, especially on the commercial side, as credit spreads decline. “We’re seeing that a lot of commercial borrowers want to go out beyond five years— seven, 10 and even 15 years,” he said, and the loans “often have 4% and 5% handles on them.”

Further, due to the lack of loan demand, competition for loans has sharply increased. “What’s happening is that a lot of these banks are just stealing loans from other banks,” Farone said.

Loan competition

Institutions today are “beating each other up” for whatever loan volume can be found among borrowers who have good credit. And in order to avoid accepting higher levels of credit risk, they are willing to accept lower loan rates than they typically would, just to put volume on the books. Thus, borrowers with good credit are “now in the driver’s seat” in many respects, he said.

Third, operating costs continue to increase and it’s leading to rising margin compression. In particular, most institutions are seeing a substantial increase in regulatory and compliance-related expenses.

“All of these costs are coming at a time when you probably have the most significant margin pressure that these banks have seen in a long, long time—without a whole lot of hope for growth,” Farone said.

Margins are continuing to come down at the same time that some institutions are doing aggressive pricing on the loan side, he cautioned. “As credit spreads are coming in, at some point, depending on where rates go, there could be danger ahead for a lot of these institutions.”

Fourth, there’s also a lot of irrational pricing on the deposit side, and in many cases it’s “far too rich” for most institutions relative to the wholesale curve, he said.

“There seems to be an inherent floor in deposit pricing, where some banks, whether they realize it or not, are going to see some pretty significant pressure on their margins going forward,” he warned. “They’re not bringing down their cost of deposits in line with the reduction in asset yields—so that margin will continue to compress.”

While many institutions have slowly brought down their CD rates, others have kept money-market accounts “still at 1% handles,” compared to average money market yields in the brokerage industry at less than 10 basis points. “You’re getting a lot of migration into money

market accounts, which makes them more rate-sensitive,” he said. At the same time, the deposit base at many institutions continues to shorten, while their assets continue to lengthen in terms of duration.

Fifth, in the regulatory arena, exams are “probably as difficult as we’ve ever seen,” Farone explained. Regulators are expecting institutions to have higher capital ratios, higher liquidity and less risk in their balance sheet.

“Concentration risk is a big issue these days,” he noted. Examiners are looking closely at concentration risk in various areas, including commercial loans, CRE, mortgage loans, and also wholesale funding.

As everyone knows, regulators today want high capital levels. “And they don’t want a lot of growth, some want no growth, and in many cases they want contraction,” he said.

“But if you follow that formula, there’s not much you can do as a bank, other than produce very minimal levels of income,” he added. “It makes things extremely challenging, to say the least.”

Given all these challenges, what’s to be done? Farone offered several practical strategies to consider as ways to contend with the pressures and strengthen bottom lines.

Cost control

“The first thing that institutions need to do is get their costs under control,” he said. For example, he predicted that the number of branches in the industry will start to diminish, as both large and small institutions take a close look at their branch structures. “And I think a lot of them are realizing, quite frankly, that they can’t support all the branches that they have,” he said.

Additionally, since a lot of banks over \$10 billion are getting out of certain business lines, such as reward debit card programs, there may be some opportunities for community institutions to step in and fill some gaps.

Likewise, many larger banks are no longer going to be offering free checking. A lot of their customers will be “in play” and no doubt looking for a new banking relationship.

Further, institutions might consider providing attractive, lowcost or no-cost loan options to the borrower. For example, instead of imposing stiff prepayment penalties in loan covenants, as most larger banks do, remove them.

Or, offer no-cost, one-time loan modifications for residential mortgages within a certain time period.

Finally, Farone advised bankers to re-evaluate their entire balance sheet to ensure that the various strategies being used are well integrated. Understand how all the specific strategies and techniques are working together and their impact on the whole.