

MARGINS EXPECTED TO NARROW FURTHER IN 2012 AND 2013 - THE CASE FOR INVESTING NOW

Major pressures continue to weigh heavily on bottom line

By Frank Farone | Darling Consulting Group

Institutions need to re-evaluate balance sheet strategies to ensure that they are effectively addressing the pressures weighing heavily on bottom lines in today's formidable economic environment. Unfortunately, far too many financial institution managers are watching their margins narrow, earnings decline, costs escalate, liquidity build and net income come under significant stress.

Going forward, such pressures do not appear likely to ease up any time soon, and will continue to present extremely challenging conditions. The recent blip up in margins "on average" is just that, a blip. Most of the margin increase was the result of lower funding costs that should have taken place long ago, but as we know, financial managers are slow to lower deposit rates as market rates decline. So now that the margin relief on the funding side has slowed while the roof continues to cave in on the asset side, expect margins to resume a downward trend with no end in sight. Unless loan demand picks up significantly or the yield curve turns upward, it doesn't look real promising.

Below, you will find some of the most common pressures now facing community financial institutions along with a number of investment strategies to consider now.

Low Rate Environment

The historically low interest rate environment appears likely to continue and, as a result, will present ongoing challenges for every institution. The biggest challenge institutions are facing in this low-rate environment is on the asset side as yields are screaming down and creating a lot of reinvestment risk. Various points on the shorter end of the yield curve have just collapsed, as well as the long end, following the Fed's rate announcement to hold rates steady into 2013 (Is this optimistic?). You're at a point where you're basically getting nothing (in terms of investment yield) out to two years. Does this mean that managers should keep funds invested overnight? (More on this question later.)

Weak Loan Demand

Loans have especially been a challenge due to continuing weak demand. What we're seeing is that net loans, quarter to quarter, continue to come down— lower levels of loans and lower yields on those loans are putting significant pressure on overall yields and ultimately income. The other thing that that's putting more pressure on institutions is the fact that there's a shrinking pie of loans and as such, relative spreads on loans are coming down fast as lenders compete aggressively on price and structure for high quality loans. Most institutions have capacity to hold more fixed rate product without the need for adding any longer term funding. However, most are not offering or holding longer-term loans. If rising rates create exposure, consider alternatives for managing against rising rates including longer term advances, interest rate swaps and/or perhaps growth strategies in a rising rate environment to offset the exposure.

Margin Compression

Another major problem that is expected to continue is margin compression. Even before this recent decline in rates, most financial institutions across the country were experiencing margin compression and low levels of earnings and that was before this recent collapse in rates. Further, the various factors underlying the current rate environment are not just resulting from the Fed's recent statements regarding the economy, but are also due to larger international issues.

To Invest or Not to Invest?

For many, the biggest challenge today is to stay ahead of the flood of cash that has been pouring into their institutions. Simply stated, most community financial institutions are "way behind the curve" in terms of investment cash flow management. Just as important is how to effectively manage the liability side of the balance sheet, namely deposit pricing.

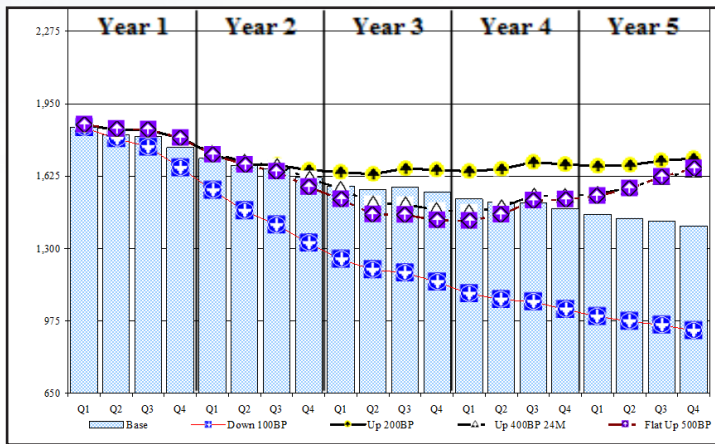
To say that the yield curve is volatile in today's environment is an understatement. It has not been uncommon to see an astute investor's preferred strategic options for optimal risk reward change from week to week over the past six months. If you are not continually reassessing the risk reward profile of available investment options (each time you make a purchase), you may not be making the right choice. It also likely requires analyzing a great many bonds, particularly in the MBS and CMO sectors. Variables such as collateral distribution, pricing, prepayment risk and structure can all make a huge difference on current and future value. Remember, you might be looking for the right structure and still have not found the right investment. So, of course, be picky!

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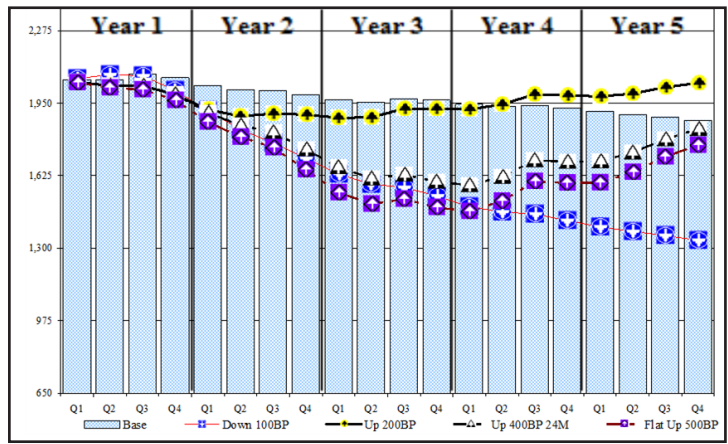
Before and After Look in the Mirror: A Case Study

The example below shows how one institution made a few minor changes to its investment portfolio mix while it also added some term wholesale funding to leverage and balance its risk. The table at the bottom shows the significant positive impact on earnings that resulted. The institution below is your typical institution that originates mortgages. They had high levels of overnight funds and were selling all loans in the current environment. Meanwhile, earnings were declining and loan levels were shrinking. After carefully reviewing the ALCO reports, it was recommended that overnight funds be extended into a blend of longer term securities with steady cash flow such as 15- and 20-year MBSs with very low premiums. Additionally, a \$25 million leverage was recommended using a ladder of FHLBank borrowings for funding. The combined net incremental results below show higher levels of income in all scenarios, less exposure to flat, falling and even rising rates, better utilization of capital and less risk to capital under a sustained falling rate environment. The base case scenario shows a net pickup of an “additional” \$2.4-\$2.6 million in NII over the first 24 months in the base case and falling rate scenarios. If rates were to rise starting now, all rising rate scenarios “still” produce a positive net increase to NII. What profile presents more risk now? The reality is that many institutions cannot afford to sit on cash and pay up for funds or wait for growth to materialize.

BEFORE



AFTER



As with any balance sheet decision, you must trust your ALCO process and do your due diligence to determine the right mix and balance of assets and liabilities including wholesale funding. For many, shrinking the balance sheet is not a viable option but rather growth is required to offset shrinking margins and income.

There are no silver bullets or one size fits all strategies; however, the few simple strategies outlined in this article are nearly universal - understand your risk position and impact to NII and NI and take appropriate action. For many, lowering deposits is the simplest and lowest risk strategy. Secondly, determine how much growth is required to offset shrinking margins and income; and lastly, measure and quantify the cost of staying short with investments versus extending out on the curve. If possible, hold more loans and determine the right mix of funding required. For many, loans can be funded with cash and cash flow. For others, a blend of the same and some longer term borrowings may be appropriate. Either way, these few simple steps will make a huge difference in earnings over the next few years when margins will most likely be under the greatest pressure in our careers. Taking no action and waiting out the storm may just be the greatest risk.

CHANGE/DIFFERENCE IN RESULTS					
	Down 100 bp	Base	Up 200 bp	Up 400 bp 24 mo.	Flat Up 500 bp
Year 1 NII	1,162	1,041	772	771	709
Year 2 NII	1,459	1,380	885	615	448
Year 3 NII	1,527	1,578	1,030	462	195
Year 4 NII	1,568	1,731	1,171	560	256
Year 5 NII	1,604	1,859	1,289	654	317

Frank Farone is the Managing Director at Darling Consulting Group where he consults nationwide with CEOs and CFOs of banks to increase earnings through the proactive management of capital, liquidity/funding risk and interest rate risk. He is a frequent speaker and author on topics such as industry issues and trends, funding solutions, regulatory issues, interest rate risk management, capital management and derivatives hedging techniques. You can contact him at 978.463.0400 or ffarone@darlingconsulting.com.