Taking Advantage of Banking Crisis Opportunities

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See Page 2 for complete article

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The current environment is creating massive cash inflows from loan pay-downs, mortgage refinancings, maturing investments, callable bonds and surging deposits as investors flee the stock markets seeking safety for their remaining capital. However, this great cash influx is coming when current Federal funds are yielding 8 to 25 basis points at best. Ouch!

Rambo Fed **to the Rescue**

Meanwhile, the Federal Reserve has announced that it will ramp up its purchases of FNMA and FHLMC mortgage-backed securities from $500 billion to $1.25 TRILLION! The Federal Reserve is also doubling up its purchase of FNMA, FHLMC, and FHLB bonds to $200 billion. And to top it off, the Fed will buy $300 billion in longer-term U.S. Treasury securities.

Immediately after the Fed's announcement, the 10 year Treasury, which had been hovering around 3%, plunged 50 basis points in the blink of an eye! These are unheard of moves in the Treasury market. These moves caused mortgage-backed securities pricing to rise significantly while mortgage rates fell to 4.89%, nearing an all time low. Many industry analysts are suggesting that 4.50% mortgage rates may be just around the corner. Consider that the lowest annual average mortgage rate seen in the 20th and 21st centuries was 4.7%, set right after World War II.

The implication of more fixed rate loan refinancing activity at rates most banks will not want to hold, combined with increased cash flow from investments, will likely be a financial institutions industry margin squeeze like never before seen!

Unprofitable Deposit Pricing

As if the roof caving in on yields is not bad enough for bankers, to make matters worse, deposit rates are being priced outrageously high relative to traditional benchmarks. What is more, large banks that are experiencing major losses and consequently deteriorating capital can no longer fund themselves through the commercial paper market. The brokered deposit market has, for all intents and purposes, dried up as well, as regulatory waivers are hard to come by these days.

These large banks have, in turn, moved very aggressively into the retail banking space to fund their operations by offering abnormally high rates on certificates of deposits and money market accounts. With long-term interest rates having fallen as low as they have, bank asset/liability managers should expect banking customers to continue rolling their money into short-term CDs and money market accounts. This migration is creating a more pronounced short-term liability structure and potentially a corresponding exposure when rates eventually rise and the inevitable shift from short-term to long-term deposits occurs. Unfortunately, many bankers have not adjusted their deposit rates in keeping with the sharp declines in asset yields and wholesale funding alternatives. The result is a stinging margin compression and lower earnings.

FDIC Assessment and FHLB Dividend Exacerbate the Problems

To add insult to injury, banks will soon be shelling out more of their earnings to cover increasing FDIC insurance rates. These escalating insurance rates will be needed to help bail out failing domestic financial institutions. At the same time, many FHLBs have temporarily reduced or eliminated their dividends. As such, some banks have turned to more expensive funding sources just to avoid having to purchase more FHLB stock.

Given these added costs and the other pressures banks face today, bank asset/liability managers must re-think how they manage the basic tenets of their business, including liquidity management, acceptable levels and sources of capital, and core earnings stability.

Don't be the ***Village Fool*!**

The best way to mitigate the sting of declining yields is to reduce rates on deposits across the board. In every market, there is bound to be at least one *village fool* who will pay premium rates to lure customer deposits. Such a strategy often tempts other banks to follow suit. Rather, the prudent A/L manager should employ benchmark pricing, possibly using their FHLB as a guide. Following this strategy may cause your bank to lose some deposits. However, the result may just be the most profitable alternative in this difficult environment.

Now is a good time to separate the wheat from the chaff. For your most loyal customers, you may want to consider relationship pricing as a way to reward their multiple business relationships with your bank. For other customers, consider the decline in deposit rates. Deploying such a deposit rate strategy may be a way of identifying rate shoppers whose relationship with your bank may be a greater expense than it is currently worth.

Let us take an extreme example and say you lower your bank's interest rates to *rational* levels and ultimately lose 10% of your deposits. Our experience suggests that such a steep runoff would be unusual. However, even with a 10% runoff, your bank would still retain 90% of your deposits but at a lower cost. This lower cost deposit base would generate from 50 to 75 basis points in operational cost savings.

But what about the loss of 10% of your bank's deposits? Recent government statistics show many banks having excess cash invested in Federal funds yielding 7-12 basis points. In effect, these funds are invested at a negative spread relative to the average deposit rates paid for the funds.

For many banks that are capital constrained or earnings challenged, de-leveraging of the balance sheet through more effective and efficient deposit pricing strategies may be the best way to increase earnings, build capital and ultimately replace those rate sensitive funds with lower cost alternatives.

Most banks can afford to let some deposits run off without replacing them. However, if the funds need to be replaced, several wholesale alternatives are much less expensive and may also provide greater flexibility. It

is important not to discard the name and contact information of depositors you may lose. Save this departed customer data for targeted promotions during the next rate cycle when it may once again become economical to raise deposit rates.

Be a Contrarian

You can be a contrarian by lowering rates aggressively and lengthening your liabilities, albeit carefully! Until the recent financial downturn, our view had been that overnight commercial paper and short term certificates of deposit were the most attractive funding sources. Now, however, our recommended strategies tend to cautiously lean toward a more defensive posture. Instead of chasing historically low yields on assets, we recommend focusing first on the liability side of the balance sheet.

In a low rate environment, banks are typically flush with cash and reluctant to borrow long-term fixed-rate monies regardless of their exposure to changing interest rates. Meanwhile, today's depositors are reluctant to purchase long-term CDs unless the offer rate is handsomely attractive. However, such high offer rates will most likely be a bad deal for your bank.

Bankers should respond by adjusting their CD yield curves to reflect current market conditions. If retail deposits remain insufficient for the bank's long-term funding needs, the wholesale markets may provide an attractive alternative. If, after lowering CD rates, your bank still has excess cash but requires longer term liabilities, consider using derivatives to obtain the least expensive long-term funding available.

Smart A/L managers always look beyond the present in preparation for the future. It is important to seek out the excellent opportunities that others miss including the current opportunity for obtaining money cheaply. High performance A/L managers are always cognizant of the marginal cost of funds. This understanding provides insights into obtaining the least cost of funding at the margin. Moreover, high performance A/L managers understand the nature of economic cycles and trends and factor these shifts into their thought process and planning efforts. They understand, for instance, that the sudden influx of cash into their bank is likely temporary and due, for the most part, to the worldwide meltdown of the capital markets.

They acknowledge that depositors are less interested in return *on* investment and may be just pleased with the return *of* their initial investment.

Investors turned savers are now funneling money into checking, savings and money market accounts at a rate similar to that witnessed in the 2000/2001 post dot-com era and the 9/11 tragedy. Every core deposit study I have ever examined has illustrated these trends:

- Depositors are less concerned with maximizing yield when rates are at near historic lows.
- In a low-rate environment, depositors enjoy the comfort and convenience of having access to their money without risking their principal.

Accordingly, A/L managers must understand and appreciate the psychology of this shift when pricing their cost of raw materials, namely money.

Many high performance A/L managers are taking full advantage of today's low rates to acquire inexpensive funds. For liability sensitive banks, A/L managers should be *preparing* now for obtaining long-term funding at the lowest possible cost. They must recognize that, when rates finally begin to rise, depositors will become more rate sensitive and typically seek higher returns. And remember, long rates will begin to increase long before the Fed initiates rate hikes.

Getting Past the "D" Word

The unusually wide spread between FHLB advances and the swap curve makes interest rate swaps extremely attractive from a cost and capital perspective. Accordingly, A/L managers should explore the use of derivatives now to gain better insights into their practical application. As one of my Southern bank clients say, "*Don't wait until the river floods before buying flood insurance!*" Become better students of the derivatives market now and get everything in place to assure that your bank can quickly implement a derivatives strategy when market conditions prove attractive. Yes, there are accounting issues and counterparty risk considerations associated with the derivatives market. However, that is not necessarily a good excuse for ignoring the practical application and effective use of interest rate swaps.

At a minimum, educate your ALCO and your board of directors on the use of derivatives. Explore the pros and cons of derivatives before totally dismissing the possibility of their use. You may be surprised at what profit opportunities you have forgone by not considering interest rate swaps. Several large commercial banks and specialty brokerage services houses have recently reentered the interest rate swap markets now that the bigger players have moved aside. These new market entrants are offering community banks smaller swap transactions with attractive pricing where, in the past, similar opportunities were not available.

The Application of *Common* Sense

The essential strategy is simple: reinvest excess cash rather conservatively, eschew marginal leverage strategies, unless accompanied by funding term extensions, and focus on your deposit pricing structure. In an industry where 1% is considered a reasonable return on assets, reducing deposit rates by 50-75 basis points or more will immediately bring a higher level of earnings than most any other yield-enhancing strategy.

There are a couple of fine points to remember, however. Approach callable bonds and other structured notes with caution as they are likely to be long-term bombs in disguise. Consider a laddered or barbell approach to bond investing. Consider investments that provide call protection and more predictable cash flows. Be prepared for a sustained low rate environment, but manage your balance sheet according to your current risk profile. This conservative approach can help assure that your bank does not get caught when rates begin to rise once again!

A Lenders Market Returns

Bank A/L managers should revisit their loan pricing methodology to ensure that loans are being priced to reflect the same risk premiums paid in the capital markets. Given that 30-year GNMAs were yielding above 6%, with zero credit risk and zero risk-based capital requirements, it would seem unwise to price fixed rate commercial loans within even 100 basis points of a 6% effective yield. This is an important point considering that GNMAs are extremely liquid. What's more, A/L managers should consider *floors in the*

money for floating rate loans at these rate levels. For instance, a Prime plus 1.00% loan should be priced at no less than a 6% starting rate today, i.e., 175 basis points in the money.

A/L managers should also revisit their fixed rate loan pricing indexes to ensure rational pricing. For example, loans priced at 300 basis points over the 5 year FHLB advance rate might be too rich and non-competitive in today's market due to the widening spreads mentioned above. These same loans might be priced too lean based on the same spread to the swap curve today. As such, A/L managers might consider pricing loans at a lower spread to FHLB today but write in the 300 basis point spread to FHLB upon repricing.

Conclusion

This economic downturn will ultimately subside and the industry will survive, albeit most likely in a different form. In the meantime, we should not lose sight of the opportunities that are currently available. A/L managers must assume some degree of risk for their banks to make money and survive. However, these assumed risks must be measured and monitored with the long-term implications fully considered. There is no *one size fits all* strategy that we can recommend to all banks. However, the few simple strategies outlined in this article will hopefully help give an immediate profitability boost as we move forward into 2009. While many bankers may be overwhelmed by the current economic maelstrom that seems to be pulling them toward what they think is the abyss, in the process they may be missing phenomenal opportunities. John Wooden put times like this in perspective when he said, "*Things work out best for those who make the best of the way things work out.*"

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Frank is a managing director of Darling Consulting Group (DCG), working nationwide with CEOs and CFOs of financial institutions to increase earnings through the proactive management of capital, liquidity/funding risk and interest rate risk. He assists clients in understanding and anticipating the effects of changing market conditions on their balance sheets, and develops and implements effective strategies based upon a clear understanding of risk/reward tradeoffs. He is a frequent author and speaker in the banking industry and is on the faculty of numerous educational and banking organizations.

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This article first appeared in the May 2009 issue of the Bank Asset/Liability Management newsletter,
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