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Revisiting ALM strategy

Major pressures continue to weigh heavily on bottom line

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, an industry strategist warns.

Going forward, such pressures do not appear likely to ease up any time soon, and will continue to present extremely challenging conditions.

"So it's going to be a very difficult second half this year," says strategist Frank Farone, managing director, Darling Consulting Group, Newburyport, Mass. "And going into 2012, unless loan demand picks up significantly or the yield curve turns upward, it doesn't look real promising."

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

Serious pressures that must be addressed include:

- Extremely low interest rates with no end in sight
- Weak loan demand
- Irrational deposit pricing
- Margin compression

First, the historically low interest rate environment appears likely to continue, and as a result, will present ongoing challenges for banks and credit unions.

At its most recent, Aug. 9 meeting, the Fed's monetary policy-setting committee warned that "downside risks" to the economy have increased. Among these, it said that: indicators suggest a deterioration in overall labor market conditions in recent months; the unemployment rate has moved up; household spending has flattened out; investment in non-residential structures is still weak; and the housing sector remains depressed.

As a result, the Fed said it anticipates that the target range for the short-term, federal funds rate will remain at zero to 0.25%—at least through mid-2013—in order to promote the ongoing economic recovery.

Farone pointed out that the Fed "made history" in announcing that it will keep short-term rates in place until 2013, since it's unusual for the Fed to set a rate policy for such a long period. He noted these financial market reactions to the Fed's announcement: loans are re-pricing down; people are refinancing on the asset side; bonds are being called; asset yields are coming in; and investment cash flows are pouring in.

Biggest challenge

"The biggest challenge banks are facing is this low-rate environment—on the asset side yields are screaming down," he pointed out. "And as yields are coming down on the long end of the curve, there has been a lot of reinvestment risk on the asset side."

Various points on the shorter end of the yield curve "just collapsed," as well as the long end, following the Fed's rate announcement, he said. "You're at a point where you're basically getting nothing (in terms of investment yield) out to two years."

For example, shortly after the FOMC made its announcement, the 10-year Treasury yield dropped below 3%. Similarly, the yield for three-months was zero; the yield for six months, 4 basis points; the yield for one-year, 8 basis points; and the yield for two years, 19 basis points.

Farone added that although the Fed set the target rate's official level at zero to 25 basis points, the actual overnight rate in the market is below that level. "You don't get that (target rate)—you get almost nothing if you want to invest on an overnight basis," he said. "There's so much liquidity that no one needs it and no one wants it."

And in recent weeks, Treasury yields hit an all-time low, with the 10-year Treasury below 2% and agency Treasury yields, as far out as two years, below 25 basis points, he added.

Secondly, for several years, 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," Farone said.

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"The other thing that we're seeing now that's putting more pressure on institutions is the fact that there's a shrinking pie of loans," Farone explained.

"Banks, quite frankly, are not pricing in risk—they are pricing their loans too low, because they are all going after that same pool of loans which is shrinking," he added.

Institutions are vigorously competing for the good loans. "The large banks are willing to go out very long on term, because they are pricing off the swap curve. And because these rates have come down so far, so fast, they are swooping in and pricing very aggressively on a relative basis," he said.

So how can community institutions counter this competition? "They've got to make the hard decision as to: how do I price these loans efficiently," Farone said. "If you're pricing off your CD curve or the FHLB curve, you're not going to be competitive—you need to look at the swap curve."

Further, he noted that both larger banks and the more sophisticated smaller institutions are utilizing derivative hedges to price longer-term, fixed-rate loan deals.

They're getting their spread by utilizing the swap market and not the retail market. The difference in cost, by using a derivative hedge versus using an FHLB borrowing, is about 80 basis points on a 10-year deal, he noted. "That's what a lot of small community banks are doing to be more competitive in the market."

Derivative strategies

However, he warned that the timing for such derivative strategies is late in the game, due to recent changes in the rate environment over the last year. "It's almost like the horse is out of the barn now," Farone said.

Further, he predicted that a new wave of mortgage refinancing will soon arrive, and bankers need to get ready.

"You're at a point where rates are so low, that I think a lot of banks haven't woken up to the fact that a whole new wave of new refinancing is likely to hit the markets over the next few months," he said. "That's going to cause even more pressure on the yields and revenues that banks are going to be able to generate moving forward."

Many loans were put on institutions' books during heavy business activity around 2006 and 2007. "A lot of five-year deals were put on at the time, and a lot of them are re-pricing now and over the next six to nine months," he explained.

He noted that many of these loan deals are rolling over and are going to re-price off the five-year point on the curve. "The smart banks didn't price off the Treasury—they put floors in those loans," he said. "But many did not—and so a lot of them are pricing off the five-year Treasury or the five-year FHLB curve."

Here's the dilemma for those institutions. "If I'm pricing all of these loans that are coming due off the five-year Treasury, that point of the curve right now is 85 basis points," he said. "So if I'm (currently) at 2.75% over the five-year point of the curve, I'm looking at some pretty low levels—and these are going to be pricing down significantly."

Liquidity flood

A third major challenge today is to stay ahead of the flood of cash that has been pouring into institutions and to set effective deposit prices to manage that liquidity. Simply stated, most community institutions are "way behind the curve" in terms of adjusting this liability side of the balance sheet, Farone said.

The FDIC said that deposits in domestic bank offices increased by $234.4 billion, or 2.9%, during the second quarter of 2011, and deposits in accounts with balances greater than $250,000 rose by $279.6 billion, or 8.8%.

More than half of this increase in deposits consisted of balances in large, non-interest-bearing transaction accounts that have temporary unlimited deposit insurance coverage. The 10 largest banks accounted for 82% ($229 billion) of the growth in such large-denomination deposits, the FDIC said.

However, while the roof may be caving in on the asset side for many institutions, one kind of "salvation" that remains is the alternative to adjust the funding side. Unfortunately, however, there's a tendency among many bankers to "wait in order to see who blinks first," he said.

"I have never seen as wide a disparity in (pricing) deposit rates between institutions as I'm seeing today," Farone explained. "I still see money market accounts out there over 1%; and I came from a client yesterday that is paying 2.75% on a five-year CD." However, he noted that in contrast, the yield on a five-year Treasury is 88 basis points.

"And, for example, I can go to the wholesale markets and get five-year funding for about 1.35%," he said. "I'm not suggesting that banks have to come down to the wholesale level, but it's ludicrous to pay 2.75% on a five-year CD today just because you paid 2.75% three weeks ago."

Since interest rates have come down, the rate levels are impacting the reinvestment of cash flows, how institutions can price loans, the refinancing risk they have in the loan portfolio, and refi risk within the investment portfolio, Farone said. "I don't think it's registered with a lot of bankers just how far rates have come down."

Fourth, a major problem now facing many community institutions is margin compression. Even before this recent decline in rates, most banks across the country were experiencing margin compression and low levels of earnings, and expecting more going forward, Farone said. "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 also are due to larger international issues. "I think you have the whole issue of what's going on in Europe"—Germany, France, Spain, Italy," he explained.

There's still a lot of uncertainty,

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and the stock market is "taking it on the chin," which reduces confidence. "And when you don't have a lot of confidence, people don't spend," he said. "If people don't spend, earnings are down; and if earnings are down—you know, it's a spiral."

Farone offered this advice. For many institutions, perhaps the most important practical strategy to consider is to get control of the liability side of the balance sheet by dropping deposit prices in a rational manner.

"There's a lot of apathy out there—a lot of depositors are less concerned with return on their money than they are with return of their money," he said.

Wholesale curve

"You've got to come down with the wholesale curve," he advised. "You can't afford to just stick your head out the window and look up and down to see what everybody else is paying; that's like the blind leading the blind—and yet we see it all the time."

"For a lot of these banks, what's happening is, their margins are coming down—and they're coming down fast because of the collapse in rates," he said. "So for many of these bankers, the only alternative at this point is to lower their deposit rates."

"How long is it going to take before they wake up and realize how margins are getting killed—we've got to make adjustments," he said. "That's probably one of the most important things that banks can do today."

"What they can't afford to do is to continue to pay up on deposits, invest in a negative yield, and watch their margins erode, and their income continue to go down, down, down," he said.

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