Difficulties Ahead for Your 2013 Budget?

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As your strategic planning and budgeting process starts to take shape, there could very well be a dangerous intersection of operating income and expenses throughout the banking industry. You may be faced with continued margin compression and lower net interest income (NII). The low rate environment will cause investment and loan cash flows to reprice lower with limited ability to meaningfully reduce deposit rates. Reviewing the past several years, in general terms, you can see that your 2013 budget will be more difficult to achieve than your 2012 budget, which was tougher than your 2011 budget.

With the Federal Reserve expected to hold short-term rates at current levels until mid-2015, banks must look beyond the 2013 budget and figure out what happens to net interest income if interest rates remain at current levels, or even go lower, until at least that point. Most banks, assuming a flat or no growth balance sheet, are projecting NII to decline each successive year in their asset/liability model simulations in the current rate scenario.

All of this begs the question, "*At what point does net interest income fall below operating expenses?*" Or said another way, when do roads converge with core business operations failing to cover overhead costs, leaving fee income and loan quality as the primary driver of profitability? Throughout the planning process this year, it will be critically important for your bank to understand how decisions made today will affect capital, loan growth, liquidity/funding, investments, interest rate risk, operations, and branch networks over the next several years.

The following discussions concentrate on some key issues that banks and their A/L managers will be faced with as they review their projections beyond 2013.

Capital. With the three federal banking agencies releasing a *Notice of Proposed Rulemaking* (NPR) regarding the definition of regulatory capital, i.e., Basel III, banks would be wise to understand their capital position *today* and their capital position as it is written *under the new proposed rules*. Without going into great detail, it is important to understand the new minimum capital requirements along with the new common equity Tier 1 to total risk weighted assets ratio. Within the numerator, all *Available For Sale* (AFS) investment securities gains and losses will now flow through regulatory capital and not *Accumulated Other Comprehensive Income* (AOCI) as it is today. In addition, some banks will have to deduct *Mortgage Servicing Assets* (MSA) and other certain *Deferred Tax Assets* (DTA). Within the denominator, Basel III would revise risk weights for residential mortgages based on *Loan To Values* (LTV) and increase risk weights for development and construction loans, as well as past due loans. While this is by no means a complete listing of the changes, the bottom line is that there will be a lot of moving parts as it relates to the bank's product offerings.

Loan Growth. How much *net* loan growth is the bank going to need to cover the NII shortfalls for the next three to five years? When backing into the *net* number needed, it is important to note that, given the current competition for good quality loans, an incremental spread that is currently 50 to 100 basis points lower than your current margin is a starting point for your discussions. In addition to the Basel III requirements, some other key questions as related to achieving the loan growth needed are:

- *Price* — Have you made concession(s) on rate to get the deal(s)? If so, how much?
- *Term or Structure* — Are you lengthening the maturity dates, waiving prepayment penalties and other covenants to make the deal work?
- *Credit Standards* — Are you writing to lower credit standards?
- *Other Risk Metrics* — Are there any other risk metrics that you are relaxing?

Liquidity/Funding. Banks are currently flush with cash, so funding loan growth seems be the last concern. However, since the financial crisis, banks have seen a larger amount of *parked* deposits, mostly in non-maturity accounts, within their balance sheets. The real challenge is trying to figure out who is a core depositor and who is just biding their time until they can find a better offer. In addition to the core deposit question, you will also need to stress test your liquidity position using many different scenarios and variables in order to highlight potential weakness within your current liquidity position. Core deposit studies and forward-looking liquidity stress testing have quickly evolved from *nice to have* to *have to have* strategic documents.

Investments. With margin pressures increasing, banks may look to their investment portfolios to help make up the shortfall. In this case, some key questions to better understand the changes within the investment portfolio are:

- Has or will the weighted average life and duration of the portfolio become longer?
- With Basel III, any gains or losses from the AFS portfolio will now flow through regulatory capital. What is the potential impact if/when rates increase 300bps or more?
- Has the credit exposure of the portfolio increased, buying non-agency securities or increasing concentration of municipal securities?
- Is the bank moving into new asset classes that the bank has not purchased before?
- Are any other investment risk metrics being relaxed?

Interest Rate Risk. Given the low-rate environment, bankers continue to see borrowers wanting long-term fixed-rate loans while depositors seek short-term products waiting for rates to rise before locking into longer-term CDs, all resulting in additional interest rate risk. Darling Consulting Group currently runs six different interest rate scenarios, five different shock scenarios, and four different stress test scenarios to capture the total interest rate risk position. If you are not — you should be. In addition, your what-if analyses should not only include traditional interest rate risk tools (i.e., extension, pre-investment, leverage, etc.), but also less traditional, and more and more commonly applied, off-balance sheet tools such as caps, swaps, collars, etc.

Operations/Branch Networks. You should consider reviewing the last five years to determine the number of transactions that have been taking place within each of your branches. With direct deposit, ACH, the Internet, remote deposit capture, and mobile banking, it would not be surprising to see the numbers of transactions at the branch level reduced by 20 to 40 percent. This leads to the question, *"Have the variable costs associated with branches dropped 20 to 40 percent as well?"* If not, now would be a good time to review how changes in the branch delivery system, such as personnel, hours of operations and locations, can help reduce those variable costs.

Summary. It is no longer business as usual. It is now more important than ever to understand the underlying issues that are driving your bank's balance sheet and operating expenses, given the current and expected rate environment. Looking ahead three to five years, the last thing you want to find yourself asking is, "*What just happened to our business model*?" Asking questions now and researching a little deeper into the details will pay current and future dividends.

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