So Where Are We Going in 2012?

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Given today's tumultuous economic environment, extraordinary pressures are weighing heavily on community bank margins, and those pressures are not likely going to be alleviated any time soon.

With the strategic planning season soon approaching, community bank management and directors will be facing some notable financial issues, including, just to name a few …

- Extremely low interest rates with no end in sight;
- Weak to no loan demand;
- Irrational deposit pricing by competitors;
- Margin compression; and
- Higher operating costs.

Too many financial institutions have been overly fixated on rising rates and more extreme rate environments. By doing so, they have lost sight of the potential for (and high probability of) a long and protracted low-rate environment and its impact on earnings and capital.

A prolonged low-rate environment is going to be problematic for many community banks as asset yields continue to decrease without commensurate relief on the funding side.

The Fed's historic announcement of its intention to keep short-term rates in place until 2013 will exacerbate margin pressures as loans continue to reprice downward and refinancing activity increases. Meanwhile, the "follow your peers" approach will likely drive investment portfolio managers to attempt reinvestment all of the excess cash flow into the same products.

Until the economy notably improves, loan demand is going to continue to be low to nonexistent and banks are going to be fighting for a shrinking pool of good credits. The heated competition has already driven some banks into under-pricing risk again—lessons too quickly forgotten. Combine this lack of new business activity with notable growth in deposits that are in many cases irrationally priced and you have a recipe for poor to no performance.

Adding to this financial challenge is the growing desire of regulators to transform your community bank into the "perfect bank"—one that has high capital, high liquidity, no credit risk, no borrowings or brokered funds, and a low interest rate risk (and consequently no earnings).

So where are we going from here?

Community bank executives and directors cannot afford to have a wait-and-see attitude toward 2012. Successful community banks are not going to sit back and hope things improve. Instead, those banks are going to seek ways to most effectively assess and communicate the short- and long-term financial effect of strategic considerations and make timely and tough decisions.

To this end, successful community banks will need to do several things in this competitive environment:

- Provide their management and directors with additional education to ensure more substantive understanding of three balance sheet and risk management concepts—interest rate risk, liquidity risk and funds management, and derivatives.
- Enhance executive and board reporting so that it simply summarizes the various risk elements/measures and provides a means for management and directors to focus on the issues needing attention (for example, risk "score carding").

- Expand policy statements to inform and educate all of the stakeholders. Accordingly, take the opportunity to clearly articulate their bank's operating philosophies and business practices so that all directors and examiners obtain a clear picture of …
  - the measurement and management process;
  - what measures are used (and not used) and how they are applied;
  - the rationale behind the policy guidelines and limits; and
  - the processes and controls in place to ensure appropriate oversight and successful execution.
- Increase directors' involvement in these balance sheet/risk management process …
  - additional review and evaluation of the risk/ return tradeoffs of various opportunities;
  - more formal discussion and approval of critical assumptions used within the asset-liability management model;
  - stress-testing parameter development; and
  - contingency funding planning.
- Engage in more proactive discussions with community bank examiners to …
  - demonstrate aptitude and understanding of balance sheet and risk profile; and
  - provide insight and education that confirms that the spirit of the regulatory guidance is being met.
- Make the tough decisions relative to …
  - investment cash-flow extension;
  - ongoing lending framework and pricing (originate and sell? hold? buy?);
  - deposit pricing and retention strategies; and
  - earnings and capital improvement versus immediate interest rate risk mitigation.

Now more than ever community bank executives and directors need to take ownership of their balance sheets and their risk management activities, and control their future—before someone else does.

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With over 25 years of experience in asset/liability management, Michael has provided technical and strategic consulting to a diverse group of financial institutions in the U.S. and abroad. Michael is also a frequent author and top rated speaker on a variety of balance sheet management topics.

During his tenure at DCG, Michael has served in various capacities, including Director of Financial Analytics. In addition, he is a technical resource for the ongoing development of many of DCG's ALM-related products and services. Prior to joining DCG, Michael managed the ALM and strategic planning process for a regional bank in the northeast.

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