The Survival Guide for Community Banks—2013 and Beyond

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The greatest risk to the majority of community banks that too few are talking about is the degree to which margins will decline—and this risk is growing larger every day, particularly now that QE "Infinity" was announced. Most community banks have underestimated the real risks associated with this low rate environment and have not properly prepared for a protracted period of shrinking margins. In fact, by the end of 2014 many community banks will discover that net interest income will be insufficient to support operating expenses.

There is some good news, however—it doesn't have to be that way. There are still opportunities for those willing to look beyond the present and prepare for the future by seeking opportunities that others miss. During this year's strategic planning session, you and your management team need to invest notable time addressing some of the key issues you face, including:

- Ongoing margin compression with no end in sight,
- Aggressive loan acquisition tactics by competitors,
- Ambiguous interest rate risk exposure,
- Challenging investment and funds management, and
- Regulatory and political uncertainty.

Margin Compression. Too many organizations continue to be overly fixated on rising rates and more extreme rate environments, and in doing so 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 problematic for most community banks as asset yields continue to decrease without commensurate relief on the funding side. With the Fed's intention to keep short-term rates in place for the next several years, margin pressures are only going to get worse. Organizations who are actively trying to address this issue are once again looking hard at funding cost reductions and their investment strategy vis-à-vis loan production and retention.

Lending—Offense and Defense. Until the economy notably improves, loan demand is going to continue to be low to non-existent and the battle for a shrinking pool of good credits is going to continue; the heated competition has driven organizations into under-pricing risk again—a lesson too quickly forgotten. Combine this lack of new business activity with continued deposit growth that is in many cases irrationally priced and you have a recipe for poor performance. You and your management team need to develop tactical ways to prevent your competitors from poaching your best customers while at the same time find ways to empower your lenders to acquire the best credits from others.

Interest Rate Risk Exposure. While many organizations' ALCO packages suggest they will gain financial relief when rates rise, for many this is a fallacy as their risk models are not taking into consideration the notable shift that will likely occur with non-maturity deposit funding. Over the past several years, most organizations have experienced notable growth in low-cost non-maturity deposits, but based upon several statistical studies we have performed, there is likely going to be a sizable reversal of this trend and low cost deposits will have to be replaced by higher costing rate sensitive CDs or wholesale funding. You and your management team need to be evaluating the potential liquidity and interest rate risk implications of this potential phenomenon by performing and discussing the results of sensitivity and stress-tests that are backed by more in-depth studies of your depositors. For organizations proactively simulating flat interest rates for two years followed by rising rates thereafter, the negative impact is even more dramatic.

Investments and Funds Management. Not much needs to be said about today's investment market. Anemic yields, undesired credit risk, extension risk, and significant price risk when rates rise all make for a very challenging situation to say the least. And with cash continuously coming in from securities, loans, and deposits, managing excess liquidity in the current low rate

environment is problematic. Organizations that have been actively shrinking their balance sheets are eventually going to reach the point when Net Interest Income can no longer support operating expenses. For this reason, deposit pricing and loan origination/selling activities are being seriously revisited by many organizations.

Regulatory and Political Uncertainty. Adding to this financial challenge is the continued drive by regulators to transform your organization into the "perfect bank"—one that has high capital, high liquidity, no credit risk, no borrowings or brokered funds, and low interest rate risk (and consequently no earnings). Now, more than ever bankers and directors need to take ownership of their balance sheets, their risk management activities, and control their future—before someone else does. Examiners are elevating their expectations for acceptable risk management practices. "Satisfactory" is no longer the benchmark of success—"exceptional" is the new normal. Add continued developments with CFPB, Dodd-Frank, new capital regulation, Basel III, the TAG question, the fiscal cliff … it all adds up to another incredibly challenging year.

Final Thoughts

Bankers and directors cannot afford to have a "wait and see" attitude towards 2013 and beyond. Organizations who wish to be successful in the long haul are going to have to seek ways to most effectively assess and communicate the short- and long-term financial impact of strategic considerations and make timely and tough decisions. To remain relevant, there are a few critical items you and your management team must consider:

- loan growth, loan growth, loan growth,
- cost reductions/cost reallocations,
- new avenues for non-interest income/fee generation, and
- securing and expanding your role in the payment system (core/reliable transaction account growth).

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