Strategic Requirements for 2013

by: Keri M. Crooks, Managing Director
Darling Consulting Group

With the new year in full gear, bankers are looking forward and facing fairly grim projections for margin and net interest income in the coming quarters. For most, the downward pressure is SO significant that 5-10% net new loan growth will be required just to maintain current NII levels. Additionally, most are recognizing that the downward pressure will only intensify as more of their existing borrowers request rate modifications. All of this at a time when organic loan growth remains extremely modest and an economic recovery continues to prove elusive. *The same themes prevalent in 2012 continue, but to a more significant degree:*

- *Very unattractive investment options for putting liquidity to work and generating interest income*. Some are currently faced with negative investment yields in their existing portfolio, as premium bonds have shortened up more than anticipated with ongoing refinance activity while municipal and corporate bonds remain an alternative for some, but will require additional *heavy lifting* for pre-purchase analysis and post-purchase monitoring in 2013 and beyond. Also factor in the reality that yields on most investments purchased today do not cover the cost of overhead at your bank.

- *Deposit rates and overall funding costs are quickly approaching zero leaving little remaining* dry powder. Most have tested *floors* on their deposit pricing and have paid down higher-cost wholesale funding with excess liquidity. *Note:* early March, average rates paid by U.S. depository institutions as calculated by the FDIC show savings @7bp, checking @5bp, MMDA @11bp and the highest rate being a 5-year CD @81bp!

- *Little new demand for credit, as exhibited by increasing competition for loans whereby rates continue to creep lower, terms are being extended beyond comfort levels, covenants relaxed and for some — a compromise on underwriting standards*. At the same time, existing borrowers continue to request rate modifications or refinance elsewhere.

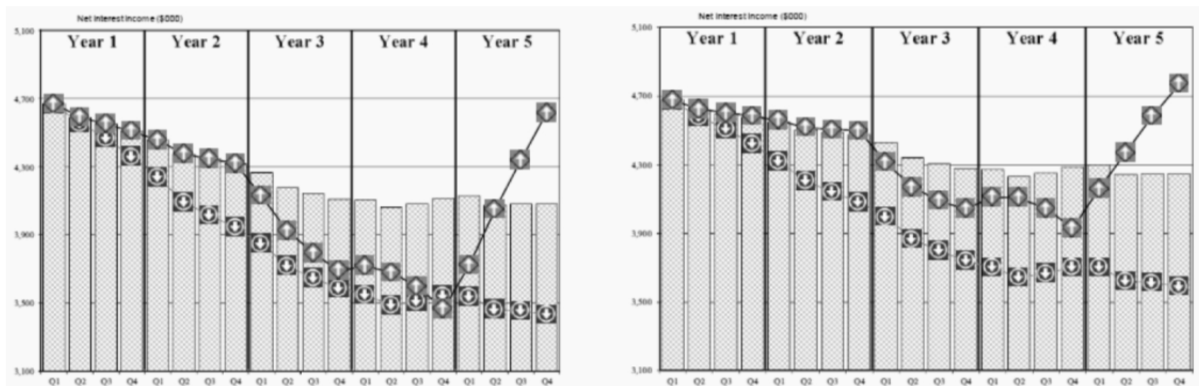
Given that these challenges are highly likely to persist, and even intensify, each bank should quantify that *hole* it will need to fill over the next two years should rates remain flat *and* re-visit current strategies for generating assets to ensure that you receive your fair and required share of the loan deals available. Loan generation will become increasingly critical as the above-

mentioned pressures continue to play out. In your search to generate loans, consider the following:

Residential Mortgage Strategy. Currently, the mortgage refinance wave remains alive and well, but you have to question how long this will continue. Most banks are recognizing meaningful one-time gains (although declining relative to last year with the recent increase in long-term rates) from the sale of mortgage production to FNMA/FHLMC or the FHLB. Considering that new local, organic loan generation appears postured to be a challenge for the foreseeable future, now is the time to re-visit this hold vs. sell strategy. Examine and discuss the pros/cons of a strategy to hold a specified ($) volume and segment (10-, 15-, 20- or 30-year) of your own mortgage production in the coming year to sop up excess liquidity and/or upcoming investment cashflow. These one-time gains are just that…one-time income generators as opposed to assets that will continue to produce a spread/return. Examine your investment alternatives in this environment which can include risks such as premium, liquidity and extension with little yield in return. Consider changing asset mix over the coming year by holding a portion of even the longest (30-year!) mortgages as opposed to purchasing bonds.

In Exhibit 7, the bank's current position is the graph on the left exhibiting a downward trend in NII under flat, falling *and* rising interest rates over the near term — a profile that is not uncommon throughout today's banking industry. The profile on the left also assumes that the bank will purchase MBS/CMO products with upcoming investment cashflows and maintain the bond portfolio (i.e., no projected change in asset mix).

Exhibit 7



The graph on the right of Exhibit 7 depicts a *barbell* approach — a strategy allocating 50% of upcoming investment cashflow towards holding its own 30-year mortgage production @ 3.50% and redeploying the other 50% into short-term cash @ 0.25% (average yield of 1.88%) vs. purchasing investments. This strategy reduces premium risk, fluctuations in unrealized gain/loss, price risk, and gives a better overall return in all rate scenarios. This is also a strategy that banks can turn *on and off* and re-visit as needed.

Loan Purchase Opportunities. The commercial lending arena will remain extremely competitive as demand for new deals intensifies while the supply of borrowers seeking new credit remains limited. Organic growth through existing local outlets will continue to be a challenge for most. As a result, we have witnessed a renewed interest in loan purchasing opportunities that have been available for some time. The products can range from CRE to C&I to auto loans and even residential mortgages. On the surface, there is an additional element of risk in purchasing loans from others out-of-market, but as you

do your homework you may find an attractive opportunity exists. Also, of note, the loan purchase opportunities referenced here are high quality, performing loans typically coming from banks that are selling for diversification purposes. Benefits of purchasing loans from other banks or networks can include: diversifying portfolio concentrations, acquiring loans without the additional staffing costs, and additional diversity in your loan strategy without engaging in local rate *wars* or competing for deal structures that are *scary* to some. Even banks that have acquired branches, banks or desirable lenders locally to obtain the necessary loan growth are re-visiting purchasing opportunities for the coming year amid growing concerns that competition will force banks to continually compromise on rate, structure and credit.

Asset generation will be the key to success in this low-rate/growth environment, and loans will continue to be the most attractive outlet. With margin continuing to come under pressure, you need to ensure that you are at least considering every available resource to improve your bottom line…leaving no stone unturned. These discussions will be *required* to stay ahead of the competition and the downward pressure coming your way in 2013 and beyond. As is the case before executing on any potential strategy, bankers should be confident that a comprehensive and accurate modeling process exists to quantify potential risks. You cannot afford to be wrong in this volatile environment.

Keri M. Crooks
Managing Director
Darling Consulting Group, Inc.
kcrooks@darlingconsulting.com
Tel: 978.463.0400
www.darlingconsulting.com

Keri joined the DCG team in 2002. She presently consults directly with ALCO groups and boards of directors at banks and credit unions in the area of asset liability management with the goal of enhancing high performing institutions. She takes a hands-on approach at developing strategies to best fit the risk profile for each bank's balance sheet, while also balancing trends and pressures alive in the current industry.

Additionally, Keri remains actively involved in advancing Liquidity360°, DCG's proprietary liquidity risk management software, and is a frequent author on balance sheet management topics.

Keri received a B.S. in Business Administration/Finance from the University of Massachusetts at Lowell and currently resides in southern New Hampshire with her family.

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