FMS Update

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Compression Plan

As margins come under increasing pressure, pricing becomes hot topic for 2017

PLANNING for a new year involves a range of disparate issues, a fair number of unknowns and many different moving parts. But as they move into 2017, most community institutions essentially face one overriding theme – tight margins and what to do about them.

In a recent article, **Vinny Clevenger** of Darling Consulting Group laid out what he believes to be the key 2017 budgeting considerations for community institutions in light of mounting margin pressure. The barn door on budgets may be closed at this point, but Clevenger pointed out in a recent interview with the *Update* that the underlying issues should be fundamental to an institution's overall strategic planning as it looks to the year ahead.

FMS Update: What are the most important things community institutions should keep in mind with respect to potential interest rate moves as they look ahead to 2017?

Vinny Clevenger: I don't think there's a one-size-fits-all approach to managing a balance sheet, because a lot of it depends on the risk profile of the individual institution and its prospects moving forward. That said, there's been some significant movement in interest rates since the election, although I would point out that interest rates – if you're looking at the Fed Funds rate and the 10-year Treasury, for instance – are basically right where they were to start the year.

So moving forward, I think margins will likely remain under pressure, which means many institutions are really going to have to consider changing the way they price their assets – that's a key issue in any discussion about rates. Of course, nobody has a crystal ball to know exactly where rates are going to go. But I do think we're going to see continued margin compression in the industry if loan pricing doesn't really change and institutions continue to arm-wrestle over the best credits.

FMS Update: What are some of the significant challenges that community institutions are going to continue to face in terms of their margins? Where do you see growth coming from?

Clevenger: The issue with margins is this – most institutions have not necessarily been worried about the initial 25 to 50 basis points of rate increases from the Federal Reserve, but above that bankers will generally acknowledge that there's going to be some pressure on their deposit pricing. While we haven't seen significant or material increases in deposit pricing at a national level, that's definitely on the horizon, particularly if the Fed moves a couple more times.

If we stay up in this "higher rate environment," and if rates are even poised to move higher, institutions are going to have to take a hard look at how they price loans, because as rates move higher and higher, they'll probably have to capitulate at some point on deposit rates. When that happens, you're either going to see loan pricing increase or institutions are just going to wind up accepting even tighter margins. So it could be a really tough environment if you don't have discipline on the deposit pricing side, while also taking a closer look at what you might be able to do differently on the loan side.

In terms of growth for most institutions, that's probably going to be related to the performance

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of the economy. We've been in a 2% GDP world for quite some time now, but if that starts to move you could potentially see heightened business investment, which could help boost margins for institutions.

> *Understanding your deposit pricing discipline heading into 2017 is critical because it's highly likely we're going to see rate increases from the FOMC, so you need to have that discipline established before those increases start happening.*
>
> *Vinny Clevenger, Managing Director, Darling Consulting Group*

FMS Update: How should community institutions be assessing and addressing their deposit bases as they head into 2017?

Clevenger: This is a concern that's been raised by many of the regulatory bodies over the past several years – that there are a lot of "parked" deposits in the industry right now. I can't tell you the number of institutions that told me subsequent to the recession that they did a great job increasing their core deposits when, in fact, a measure of that was really just people parking their money for a return of their principal, as opposed to a return on their principal. So as institutions began to see the accumulation of those "core deposits," they recognized that they could be dealing with quite a bit of flight risk.

A lot of institutions in the last several years have drilled down to take a harder look at their deposits, trying to specifically hone in on their largest account relationships and look at the common characteristics of those relationships. Are the balances going up or down, and most importantly why are they going up or down? I think at some point when money market rates start to move up and become more competitive, you may see some flight risk. But the truth is that the Dow is up over 19,000 and real estate has had a significant recovery in many markets, and yet deposit levels are still pretty resilient in most community institutions.

So the industry has been fortunate that there hasn't been a mass exodus of deposits thus far. The key for institutions at this point is to dive down into their deposit bases to get a deeper understanding of what's going on there so they can be prepared if they start to see some real movement. Because it makes a lot of sense to have something else ready to potentially retain some of those deposits if those outflows start happening, whether it's a different CD special or some kind of promotional account. You just don't want to wake up one day and see 5% of your deposit base heading out the door and not be prepared for it.

FMS Update: Do you anticipate credit risk becoming a bigger issue for community institutions in the coming year? What can they do to better address this risk?

Clevenger: If you look at Call Report data, there really haven't been a lot of credit issues over the past several years – with low interest rates and low unemployment, things have been pretty quiet in that respect. If you have an improving economy and you have relatively low unemployment, historically default rates are going to remain pretty much where they are today.

But if those factors start to shift, it pays to understand where you are and to be prepared – for both yourself and your examiners. It makes sense to take a hard look at your credit, get a better understanding of where the real exposures reside in that portfolio, stress test to understand your capabilities to absorb potential losses and formulate a contingency plan in the event issues emerge.

FMS Update: What are the one or two recommendations that you would make to almost any institution in regard to its planning process heading into 2017?

Clevenger: First and foremost, I'd make sure I had a clear game plan for deposit pricing as rates increase. What are our disciplines moving forward? Are we going to react when a competitor comes to market with a high-rate special, or are we going to let them do that knowing that their margins are going to be impacted as a result? Understanding your deposit pricing discipline heading into 2017 is critical because it's highly likely we're going to see rate increases from the FOMC, so you need to have that discipline established before those increases start happening.

The other big thing to look at on the other side of the balance sheet

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is to determine at what point you're willing to walk away on rates with respect to some of your loan deals. Are you still pricing at 2016 levels for your best credits? Are you prepared to price higher heading into 2017? That's not a mindset that changes overnight! That psychology has to change if margins remain under perpetual pressure. ■

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