Perspectives

A publication of the Financial Managers Society

FACING A PAUSE, BANK MANAGERS MUST STAY VIGILANT

By Scott Hildenbrand, Principal, Balance Sheet Analysis and Strategy, Sandler O'Neill + Partners

The U.S. economy remains strong, but there are clouds on the horizon. Unemployment is low, wages are rising and inflation appears contained. That said, in January U.S. consumer confidence, presumably sapped by the federal government shutdown and market turmoil, touched its lowest level in over two years. Trade tensions remain high, global growth continues to cool and a hard Brexit could send shockwaves across the Atlantic. We fear that renewed market volatility could feed into the real economy through reductions in consumer spending or business investment, thus hastening a recession.

Against this backdrop, the Federal Open Market Committee has decided to take a breather. Since the announcement, some officials have suggested that the Fed Funds rate could even hold the current range for the rest of the year. So what does a pause mean for U.S. banks?

A pause could prolong the economic cycle, which might translate into higher demand for loans and mute credit costs near-term. Still, since the announcement, the yield curve has remained flat, reflecting a strong bid for quality in these uncertain times, while funding pressures have remained acute.

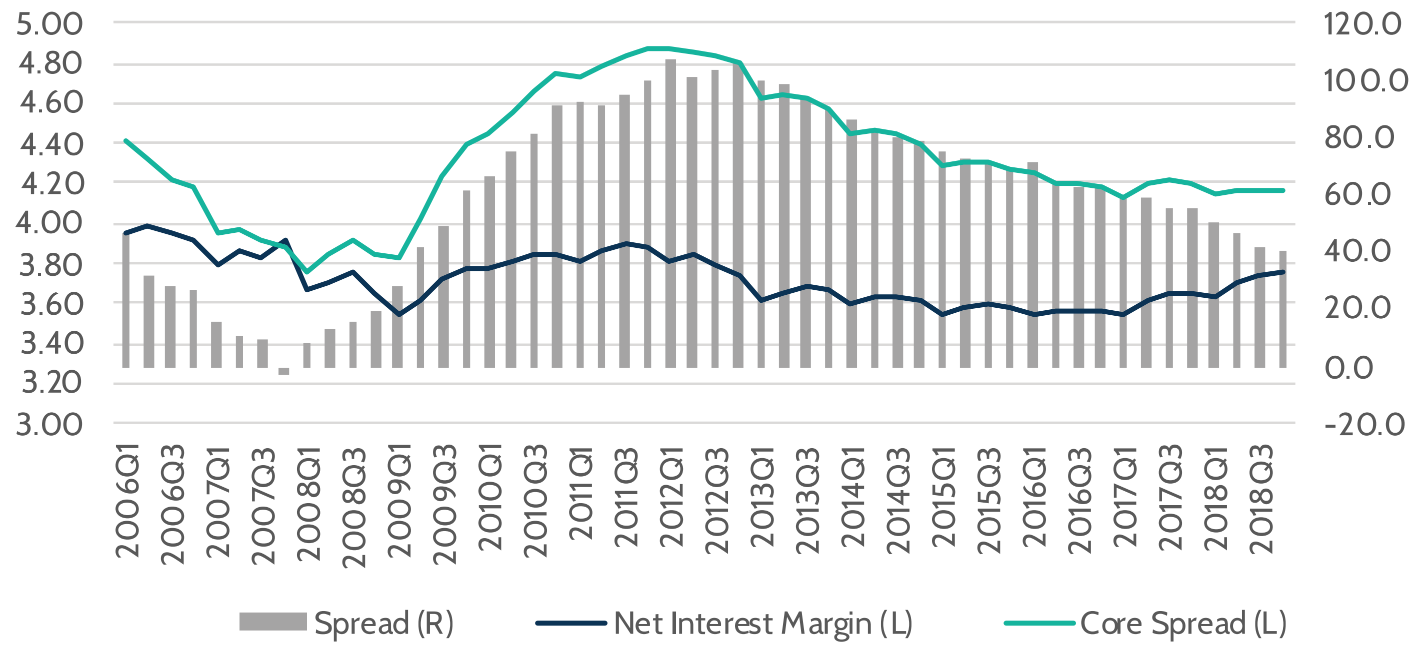
The key question facing bank managers, investors and regulators is whether a pause will relieve deposit cost pressure at small and medium-sized banks. Unfortunately, we don't see this happening.

Fundamentally, we believe that deposit costs are more a function of market dynamics than the absolute level of interest rates. Since the Great Recession, the deposit market has become even more concentrated, new entrants have been paying up for share, and technology has empowered consumers to find the best rate and transfer funds with one click – debasing or even disintermediating personal relationships from the deposit-gathering process.

Simultaneously, small and medium-sized institutions have been driving net interest margins by depleting on-balance sheet liquidity (cash and cash equivalents, marketable securities, salable loans). Fast forward to today, the median small or medium-sized bank's loan-to-deposit ratio is approaching a cycle high while its securities portfolio is plumbing a fresh cycle low. Such low levels of on-balance sheet liquidity force banks to pay up to source or retain the marginal deposit. Structurally, small and medium-sized banks are price takers.

We saw more evidence of this phenomenon in the fourth quarter of 2018. On a year-over-year basis, core spread (yield on loans and leases less the cost of interest-bearing deposits) contracted four basis points to 4.16%. As for the dynamics, the yield on loans and leases advanced 35 basis points to 5.19%, while the cost of interest-bearing deposits rose 39 basis points to 1.04%. Moreover, the spread between core spread and NIM continued to tighten. The challenge is that, without remixing, NIM and core spread should move in relative lock-step, potentially pressuring earnings and profitability metrics.

FIGURE I: NET INTEREST MARGIN AND CORE SPREAD[1]



Core Spread Components (%)	4Q15	4Q16	4Q17	4Q18
Yield on Loans and Leases	4.77	4.72	4.85	5.19
Cost of Interest-Bearing Deposits	.50	.53	.65	1.04
Core Spread	**4.27**	**4.19**	**4.20**	**4.16**

On-Balance Sheet Liquidity (%)	4Q18	Cycle Avg.	Diff (%)
Median Liquidity Ratio	14.5	16.3	-1.8
Median Loan-to-Deposit Ratio	91.6	87.5	4.1
Median Securities-to-Assets Ratio	14.5	17.5	-3.0

[1] Average yield on loans and leases less average cost of interest-bearing deposits.
Sample: Banks with assets between $1 billion and $10 billion at December 31, 2018.
Source: Regulatory data as aggregated by S&P Global Market Intelligence.

In such a challenging operating environment, banks must stay vigilant and focus on the fundamentals.

8 BEST PRACTICES FOR CREATING FRANCHISE VALUE LATE IN THE ECONOMIC CYCLE

Strengthen your core. The goal is better banks, not just bigger banks. Banks should focus on improving core pre-tax, pre-provision return on assets (core PTPP ROA; core earnings excludes nonrecurring accruals, such as securities losses or one-time gains). Core PTPP ROA excludes volatile credit metrics and tax strategies, exposing a bank's true earnings power and allowing for apples-to-apples benchmarking to high-performing and regional peers. Critically, a stronger core PTPP ROA protects earnings and capital from higher credit costs. Of course, we fully appreciate that a bank's primary responsibility is to deliver a compelling risk-adjusted return on the capital entrusted to it by shareholders. Having said that, we believe that at this point in the cycle, focusing on return on assets (ROA) will drive a higher return on equity (ROE) over the long run.

Align incentives with desired outcomes. Specifically, consider incorporating core PTPP ROA into short and long-term incentive plans. Doing so creates space for forward-looking, franchise-enhancing tactics (a loss trade, liability restructure, branch rationalization, etc.). Also, within short-term and long-term incentive plans, make sure that the weights assigned to loan and deposit origination, fee generation and credit look-backs reflect the institution's objectives and risk tolerance.

Weaponize the inverted swap curve to reduce funding costs. Recent simplifications to hedge accounting have made hedging much more viable for community banks, and various off-balance sheet strategies are worth exploring due to these changes and market pricing. One such strategy synthetically creates fixed rate funding, reduces funding costs and creates accounting symmetry in other comprehensive income (OCI), protecting GAAP capital from higher rates. Bank managers must have a firm grasp of their off-balance sheet options, and begin the education process well before they project needing to implement.

Create shelf space for higher funding costs through a securities portfolio optimization. Take advantage of the rally in the bond market to optimize the securities portfolio. Loss programs can be tailored to enhance book yield and core earnings. Since most of the unrealized loss is already housed in OCI, GAAP capital ratios should not move meaningfully (though regulatory ratios will decline). As always, managers have to consider the impact on duration, convexity and credit profiles.

Challenge managers to think broadly about their options. For example, numerous public banks have asked whether they should pursue a loss trade or repurchase stock. In our judgement, viewing these two tactics as mutually exclusive is far too restrictive; for the right story and balance sheet, they can be mutually reinforcing. Imagine a scenario in which management announces a share repurchase program with clearly defined earn-back parameters. This signals that the stock is cheap in the current range. In conjunction, management announces a loss program, which will bolster core earnings and profitability metrics. This signals that management is pulling every lever to drive high-quality earnings, which amplifies the signal from the buyback, creating a positive feedback loop.

Price loans for late cycle risk. The Federal Reserve's Senior Officer Loan Surveys show that banks are reluctant to increase loan rates over cost of funds, with 80% of respondents to the January 2019 survey saying that loan rates over cost of funds remained unchanged or narrowed over the past three months for commercial and industrial loans or credit lines to large and middle-market firms. Furthermore, 90% of banks that reported loosening credit standards cited more aggressive competition from other banks or nonbank lenders as a reason for doing so. In short, banks are letting other institutions dictate their risk-adjusted return parameters. We've seen this movie before and we know how it ends: badly. The bottom line is that corporate credit spreads have widened and we're in the latter innings of the economic cycle, both of which mean that loan pricing models and new loan rates should be adjusted in turn.

Focus on risk-adjusted returns, not accounting designations. Banks often say that they only take credit risk in their loan portfolios. We encourage banks to be more flexible, focusing more on risk-adjusted returns and less on specific instruments. For example, if the board has authorized the purchase of national syndicated loans, an institution should also take a look at high-quality collateralized loan obligations (CLOs). Of course, everything must be done in moderation – we're simply encouraging flexibility without overly restrictive accounting designations.

Create "self-help" through expense rationalization. As revenue headwinds gain force, cost takeout will become increasingly important to sustain earnings growth. Branch networks remain ripe for review as consumers migrate to digital delivery channels. Once savings are identified, take a hard, honest look at mobile and online budgets. If you're light, reallocate a portion of the brick and mortar savings, and let the residual fall to the bottom line. Remember that playing catch-up is always more expensive.

COMMUNICATE PROACTIVELY WITH ALL STAKEHOLDERS

At this point in the cycle, it's back to basics for banks. A critical but often overlooked fundamental business practice is to communicate strategic or tactical shifts, clearly and succinctly, to all stakeholders – customers, regulators, investors and employees. All stakeholders should readily acknowledge that bankers have to navigate the trade-offs among soundness, profitability and growth continuously with no margin for error. They should also acknowledge, in an honest and forward-looking moment, that safety and soundness is the most important leg of the banking stool. So as you weigh your options, make sure that you can explain how your final decisions reinforce your commitment to these essential, mutually dependent principles.

Disclaimer: The views and opinions expressed in this article are those of the author and do not necessarily reflect the official policy or position of the Financial Managers Society.

ABOUT THE AUTHOR

Scott Hildenbrand is a Principal and Chief Balance Sheet Strategist at Sandler O'Neill + Partners, L.P. He heads the Balance Sheet Analysis and Strategy group, which works with financial institutions on asset-liability management, capital planning and investment portfolio funding and hedging initiatives.

Published by:

FMS Financial Managers Society

1 North LaSalle St., Ste. 2225 | Chicago, IL 60602 | info@FMSinc.org

Contact: mloehrke@FMSinc.org | 312-578-1300

FMSinc.org/IndustryInsights