THE KAFAFIAN GROUP INC.
...helping banks perform better™

Performance Measurement | Strategic Management | Profit & Process Improvement | Board & Management Advisory Services | Financial Advisory

Second Quarter 2013 Volume 5 Issue 2

TKG Perspective

Events

Teaching & Speaking Engagements

Pennsylvania Bankers Association
PBA Advanced School of Banking
The Penn Stater Conference Center
State College, PA **July 14-19**
How Do Banks Make Money?

Pennsylvania Bankers Association
PBA Advanced School of Banking
The Penn Stater Conference Center
State College, PA **July 15**
Information Strategy

Maryland Bankers Association
Banking School
University of Maryland Inn & Conference Center
College Park, MD **July 29**
Financial Statements

Pennsylvania Association of Community Bankers
Annual Convention
Boston Marriott Copley Place
Boston, MA **September 23**
Things I Think Banks Should Do, But Generally Don't

Conferences, Conventions & Other Events

AMIfs Institute
Comprehensive Performance Management
Washington University
St. Louis MO **July 15-19**

New Jersey Bankers Association
2013 Golf Outing
Fiddler's Elbow Country Club
Bedminster, NJ **August 12**

Pennsylvania Association of Community Bankers
136th Annual Convention
Boston Marriott Copley Place
Boston MA **September 20-23**

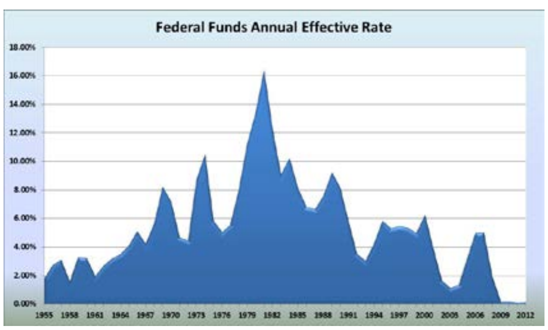
New Jersey Bankers Association
Senior Management Conference
The Revel
Atlantic City NJ **September 27**

The Impact of Low Interest Rates on Net Interest Margin and Performance

By Robert E. Kafafian, President & CEO

The current and protracted low interest rate environment has played havoc on net interest margins and resulting bank performance and profitability. Banks have historically made money by borrowing short and lending long in a normal rate environment and with a normal sloping yield curve, and/or otherwise being compensated for taking on credit and/or interest rate risk.

The first question is what is a normal rate environment? While this cannot be precisely defined, it is fair to say that today's low interest rate environment is not normal, nor were the high rates experienced in 1981. Witness the Federal Funds rate between 1955 and today in the following graph.



The second question is what is a normal sloping yield curve? Again, while this cannot be precisely defined, it is clear that we will be challenged if our cost of funds approach a floor and asset yields continue to contract, as is the case in many financial institutions today. An inverted or negative yield curve would likely have an even more negative impact.

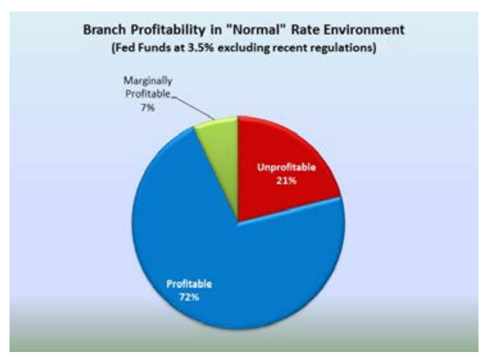
The simple fact is that deposit rates cannot go below zero (although a few banks have tried), and most banks are reaching the point where it is becoming increasingly difficult to lower rates much further. Additionally, as banks collectively chase good credits, competition is driving asset yields to unforeseen territory.

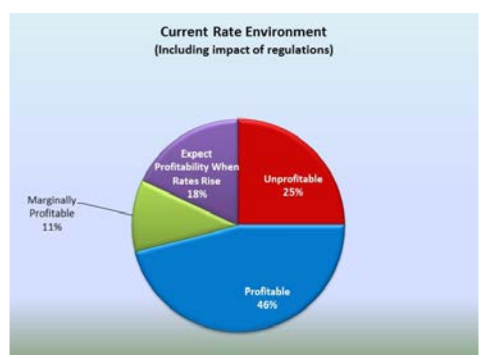
The impact of all of this is that deposit products and an increasing number of branches are currently operating at a loss.

Given that most community banks have limited fee based lines of businesses that often operate at best breakeven, the asset spread products are left to carry the day, even at lower yields. Is it any wonder that profits in the industry will be challenged until more normal rates return?

Branch Profitability

Prior to 2008, TKG estimated that a branch would breakeven on a direct cost basis at $10 million in deposits, breakeven on a fully absorbed basis at $15 million in deposits, and begin to contribute the equivalent of a desired ROA (80-100 bps) at $25 million in deposits. All of these scenarios assume an equal mix of checking, savings/money market, and time deposits. Given today's interest rate environment and the natural inflation of branch operating expenses, the breakeven points for each category are at least $15 million higher. See the difference in branch performance under normal circumstance versus the current rate environment in the following charts.





Some might ask, “Does this mean we should close smaller branches, or perhaps discourage incremental core deposits (checking/savings/money market)?” The answer, with regard to core deposits, is absolutely not. Part of this answer is the level of an individual bank’s loan/deposit ratio, ability or inability to generate loan volume, and capital adequacy. Regardless of these ratios and volumes, the incremental spread on core deposits is meaningful and core deposit profitability will widen significantly in a rising rate environment with a positive sloping yield curve. It should also be noted that core deposits correlate highly to stock price valuation. See TKG’s performance measurement clients current spreads on deposit products for a better understanding of why CD’s are not a great alternative in any rate environment.

TKG Deposit Product Profitability
(4QTR 2012)

	Non-Interest Bearing DDA	Interest Bearing DDA	Money Market	Savings	Time Deposits
Credit For Funds	2.10 %	2.29 %	1.09 %	2.18 %	1.32 %
Interest Expense	0.00 %	0.25 %	0.40 %	0.23 %	1.38 %
Total Interest Spread	**2.10 %**	**2.04 %**	**0.69 %**	**1.95 %**	**(0.06)%**

The Conundrum

Over the past year, most banks have begun to return to more normal levels of profitability. Unfortunately, much of this performance has resulted from decreased provisions for loan losses. The challenge now is how to grow earnings if interest rates stay low for an extended period of time. An additional concern is the speed at which the Fed begins to move rates higher. A rapid climb could set off another round of interest rate risk for many banks.

TKG recently measured the impact of the current low interest rate environment extended through the end of 2015 on our profitability measurement clients using matched-term Funds Transfer Pricing (“FTP”). FTP utilizes market driven indices such as the FHLB advance curve, or LIBOR curve to independently assess the cost of funds for the asset side of the balance sheet (loans and investments) and the credit or value of funds on the liability side of the balance sheet (deposits and borrowings).

After applying FTP to loans, investments, deposits and borrowing, the results indicated that the average bank would lose 6 bps of margin per quarter for the next two years. The net effect would be a decline in net interest margin of almost 50 bps. As stated earlier, this is the result of the inability to meaningfully lower deposit and borrowing costs much further, while the competitive nature of the asset side of the balance sheet continues to drive asset yields lower. TKG’s performance measurement Bank clients average a margin of 3.47%, while our Thrift clients average a margin of 3.18%. The national average of all Banks and Thrifts is approximately 3.00%. Imagine each of these groups losing 50 bps of margin over the next two years.

So what are Banks to do?

The best way to independently measure lines of businesses, spread based products, and customer profitability is to incorporate matched-term FTP. It’s clear to see that the value of a non-interest bearing checking account in the rate environment that existed in 1981 is huge, given the fact that someone is willing to maintain a balance at a zero rate when savings and money market rates were in the high teens. Conversely, when the Fed Funds rate is below 25 bps, the credit or value of that same deposit in the marketplace often isn’t high enough to cover operating costs net of fees.

Standing by and waiting for higher rates is not a viable option for most banks. Therefore it is critical to consider some or all of the following options:

- Better understand the performance of your organizational units, lines of businesses, product lines, and customers.
- Emphasize areas that provide the best returns. Either improve, deemphasize, or jettison low performers. Be careful about using the word jettison with customers, since it is always better to work on improving customer relationships and resulting performance as opposed to chasing them out of the bank.
- Continue to emphasize lower cost core deposits and high balance relationships. Core deposits are desirable in any rate environment and average balances are the largest driver of profitability.
- If your cost of funds is greater than 50 bps, or especially greater than 75 bps, there is still room to lower rates. Customers are less rate sensitive than they have ever been or maybe will be. Those that are still shopping primarily on rate are never your best customers in any environment.
- Technology is rapidly taking over as the primary delivery channel. Examples include business Internet banking, remote capture, bill pay, mobile banking, ACH, etc. Consider closing or consolidating branches that have less than $25 million in deposits, or have little chance of exceeding this level within a 3-5 year period. Market demographics and competitive environment for each branch market must be utilized to assist in making these decisions. For example, if the market area has an average branch size of less than $40-$50 million, it is probably saturated and growth will be a challenge.
- Assess your loan to deposit ratio and if it is lower than 80%, you may find that low investment portfolio yields or excess cash are costing you money. Sometimes a good credit at a lower yield is better than an investment instrument at virtually little to no yield.
- Evaluate alternative lending instruments to diversify your portfolio risk and maintain yield. For instance, a number of our clients have utilized “pick your own term” mortgage loans to satisfy customer needs, as well as mitigate interest rate risk. A few others have had success with indirect auto lending in certain markets targeting quality credits.
- Don’t sacrifice credit quality for yield. Reaching too far for yield is still a tenuous practice which should be avoided at least until real recovery is more certain. In addition, don’t sacrifice credit quality for volume. Be sure you’re being paid appropriately for taking risk.
- Be careful of the interest rate risk trap: extending maturity to maintain yield. One thing is certain, rates will eventually rise and a repeat of the savings and loan crisis should be avoided at all costs.
- Look for fee income opportunities to offset margin compression, particularly in the small to medium size business banking market.
- Manage your growth over the long term so that as you grow balances, operating expense per product and your efficiency ratio decline. Continued cost management is essential.

Remember, those that successfully transition through the next several years will find fewer competitors and a more favorable operating environment to assist in achieving high performing status.

TKG, as part of our consulting and advisory engagements, frequently evaluates our industry, its trends, successes, and challenges. We are pleased to share our thoughts with you, our valued clients and friends, in the form of this periodic newsletter. If you would like to discuss anything further, or learn more about our performance measurement, strategic planning, regulatory assistance, profit/process improvement or financial advisory services, please call us at (973) 299-0300 or visit us at www.kafafiangroup.com.

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