THE KAFAFIAN GROUP INC.
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Performance Measurement | Strategic Management | Profit & Process Improvement | Board & Management Advisory Services | Financial Advisory

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TKG Perspective

Teaching & Speaking Engagements

Pennsylvania Bankers Association
School of Banking
The Penn Stater Conference Center
State College, PA **June 7**
Strategic Decision-Making and Organizational Structure

Maryland Bankers Association
Annual Convention
The Breakers
Palm Beach, FL **June 3-7**
Delivery Channel Trends

American Bankers Association
Stonier Graduate School of Banking
University of Pennsylvania
Philadelphia, PA **June 10**
Stress Testing for Community Banks

Financial Managers Society
The Forum
Hyatt Regency Grand Cypress
Orlando, FL **June 11**
Mutual, Credit Union, Shareholder Owned: Delivering Value to Your Constituencies

Conferences, Conventions & Other Events

Massachusetts Bankers Association
Annual Convention
Ritz Carlton
Naples, FL **May 3-6**

Maryland Bankers Association Council of Professional Women in Banking and Finance
Annual Conference
College Park Marriot
Hyattsville, MD **May 3**

New Jersey Bankers Association
Annual Conference
Marco Island Marriot
Marco Island, FL **May 16-20**

Pennsylvania Bankers Association
Annual Convention
Ritz Carlton
Naples, FL **May 16-19**

New Jersey Bankers Association
Women in Banking Conference
The Palace at Somerset Park
Somerset, NJ **June 13**

Is Your Bank Positioned to Benefit from the Continued Rise in Market Interest Rates?

By: Gregg J. Wagner, Managing Director

Times are looking pretty good for community financial institutions. While we can always find something to complain about, we are working within an environment where Washington is beginning to ease the regulatory burden, loan quality is sound and the new tax plan makes the outlook for earnings even brighter. When things are going well, it provides a good opportunity to take a look back to see how we got here and to see how we can begin to plan for the future when times may not be so sunny. A surfer knows their ride on a great wave will not last forever. They may fall off their board or the ride will eventually end when the wave hits the shoreline (or there may be a shark lurking in the water that may abruptly end their ride).

Let's take a look at the impact of higher interest rates on both earning assets and deposit & borrowing spreads with some good news and some not so good news.

- The "not so good news" first: The net interest spread on earning assets peaked a few years ago and is continuing to decrease (but it is still higher than the deposit & borrowing spread).
- The "good news": The net interest spread on deposits & borrowings hit its low point a few years ago and it continues to increase!

Is your community financial institution positioned to continue to ride the wave to stronger earnings? Let's review the net interest spread on earning assets and deposits & borrowings during the last few interest rate cycles. To get some perspective, let's take a look at the changes in the Fed Funds Rate back to 2006:

Table A

	Q4 2006	Q4 2007	Q4 2008	Q4 2014	Q4 2015	Q4 2016	Q4 2017
Fed Funds Rate	5.25%	4.25%	0.25%	0.25%	0.50%	0.75%	1.50%

As you can see in Table A, once the Fed decided to lower rates they did not waste time. The Fed began lowering rates in September 2007 and by the end of 2008 they were down to 0.25%. Now let's take a look at how these lower rates impacted net interest spreads. Tables B and C below show PEER historical spreads for earning assets and deposits & borrowings from The Kafafian Group's Performance Measurement clients.

The most important detail to take away from a review of Tables B and C is to note at Q4 2006 the net spread on deposits & borrowings of 1.90% exceeded the net spread on earning assets of 1.65%! Also note that the impact of lower market rates positively impacted earning asset spreads, while they negatively impacted deposit & borrowing spreads. The net spread on loans increased to 2.50% in the 4th quarter of 2014, while the net spread of deposits & borrowings hit bottom at 0.98% during the same quarter. Let's take a closer look at how this transpired.

Table B

Earning Assets - PEER	Q4 2006	Q4 2007	Q4 2008	Q4 2009	Q4 2010	Q4 2011	Q4 2012	Q4 2013	Q4 2014	Q4 2015	Q4 2016	Q4 2017
Yield	6.37%	6.64%	5.73%	5.05%	4.81%	4.66%	4.29%	4.14%	4.10%	3.84%	3.82%	3.91%
Cost of Funds	4.72%	4.72%	3.86%	2.89%	2.52%	2.19%	1.85%	1.66%	1.60%	1.64%	1.63%	1.89%
Net Spread	1.65%	1.92%	1.87%	2.16%	2.29%	2.47%	2.44%	2.48%	2.50%	2.20%	2.19%	2.02%

Table C

Deposits & Borrowings - PEER	Q4 2006	Q4 2007	Q4 2008	Q4 2009	Q4 2010	Q4 2011	Q4 2012	Q4 2013	Q4 2014	Q4 2015	Q4 2016	Q4 2017
Credit For Funds	5.04%	4.89%	3.60%	2.56%	2.35%	2.11%	1.79%	1.64%	1.52%	1.52%	1.59%	1.83%
Interest Expense	3.14%	3.45%	2.55%	1.66%	1.27%	1.02%	0.76%	0.58%	0.54%	0.50%	0.52%	0.64%
Net Spread	1.90%	1.44%	1.05%	1.06%	1.08%	1.09%	1.03%	1.06%	0.98%	1.02%	1.07%	1.19%

Table D shows the net spread on commercial mortgages from Q4 2006 to Q4 2017 (the cost of funds is based on the duration and rate characteristics of each loan). The impact on loans from the decrease in market rates was positive. This was due to the fact that while banks saw their cost of funding decrease, they were able to maintain loan rates that provided them with a larger spread.

Table E illustrates the impact of lower rates on commercial mortgages. While the yield on commercial mortgages decreased 211 basis points, the cost to fund these loans decreased 311 basis points resulting in an increase in spread of 100 basis points. But as market rates began to rise in 2015, loans began to see their spreads decrease (note the decrease in net spread from Q4 2014 to Q4 2017 in Table D. Have you been able to substantially increase your commercial mortgage rates during the last year? Probably not.

Table D

Commercial Mortgages - PEER	Q4 2006	Q4 2007	Q4 2008	Q4 2009	Q4 2010	Q4 2011	Q4 2012	Q4 2013	Q4 2014	Q4 2015	Q4 2016	Q4 2017
Yield	7.13%	7.33%	6.31%	5.85%	5.96%	5.76%	5.50%	5.04%	5.02%	4.57%	4.42%	4.53%
Cost of Funds	4.69%	4.72%	3.74%	2.78%	2.81%	2.49%	2.14%	1.79%	1.58%	1.70%	1.68%	1.91%
Net Spread	2.44%	2.61%	2.57%	3.07%	3.15%	3.27%	3.36%	3.25%	3.44%	2.87%	2.74%	2.62%

Table E

Commercial Mortgages - PEER	Q4 2014	Q4 2006	Change
Yield	5.02%	7.13%	-2.11%
Cost of Funds	1.58%	4.69%	-3.11%
Net Spread	3.44%	2.44%	1.00%

Table F shows the net spread on money market accounts from Q4 2006 to Q4 2017. The impact on deposit product net spreads related to the decrease in market rates was negative, since market conditions did not provide banks with the opportunity to lower deposit rates below 0.00%.

The money market product reached its lowest spread the 4th quarter of 2014. Table G illustrates how the credit for funds decreased 413 basis points from the 4th quarter of 2006 and the interest expense only dropped 291 basis points resulting in a 122 basis point decrease in the money market product net spread.

Table F

Money Market - PEER	Q4 2006	Q4 2007	Q4 2008	Q4 2009	Q4 2010	Q4 2011	Q4 2012	Q4 2013	Q4 2014	Q4 2015	Q4 2016	Q4 2017
Credit For Funds	5.01%	4.93%	3.73%	2.50%	1.83%	1.43%	1.08%	0.93%	0.88%	1.01%	1.29%	1.58%
Interest Expense	3.20%	3.47%	2.00%	1.11%	0.78%	0.55%	0.39%	0.30%	0.29%	0.29%	0.36%	0.53%
Net Spread	1.81%	1.46%	1.73%	1.39%	1.05%	0.88%	0.69%	0.63%	0.59%	0.72%	0.93%	1.05%

Table G

Money Market - PEER	Q4 2014	Q4 2006	Change
Credit For Funds	0.88%	5.01%	-4.13%
Interest Expense	0.29%	3.20%	-2.91%
Net Spread	0.59%	1.81%	-1.22%

We provide our clients with a credit for funds based on the average duration of their deposit products. The longer the duration of a deposit product, the longer we go out on the FHLB Fixed-Rate Advance curve to calculate its credit for funds. Since the credit for funds for non-term deposits is priced using duration pools that are developed by rolling averages, the credit for funds lags the actual change in rates. The shorter duration of a deposit, the faster its credit for funds will increase in a rising rate environment. Referring back to Table F you will see how the rise in market rates beginning in 2015 has positively impacted the spread on money market accounts.

How can you position your financial institution to benefit from future anticipated increases in market rates?

The answer is core deposits, core deposits, core deposits………

Financial institutions with higher core deposit levels should continue to see improvements to their overall net spread on funding. Historically, financial institutions have passed on between 15 and 20 basis points of the first 100 basis point increase in Fed Fund rates to their customers in the form of higher deposit rates. For the second 100 basis points in Fed Fund rate hikes, banks pass on an estimated 40 to 50 basis points to their depositors. If your financial institution is using borrowings and brokered deposits to fund a majority of your loan growth, your future earnings may be suppressed since you will feel the impact of rising rates faster than banks more dependent on funding via core deposits.

Financial institutions that have established strategies to fund loan growth with a majority of core deposits are in position to ride the wave of strong bank earnings into the future. If your financial institution is funding a majority of its loan growth with borrowings, there may be a shark waiting in the water that may shorten your opportunity to grow earnings.

Our Performance Measurement service is designed to provide institutions with profitability information for their organizational profit centers and for the products they offer. Our clients also use data from these profitability systems to feed customer level data into their MCIF and CRM systems. Over the years we have provided this service to hundreds of institutions so they can foster an accountability culture and improve their bottom line results. One of the most valuable components of our service is compiling PEER information our clients can use to measure against their performance.

Are you interested in learning more about how your bank can utilize performance measurement information to make more informed decisions to enhance the profitability of your organization and products? If so, please contact me at gwagner@kafafiangroup.com or give me a call at 973.299.0300 ext. 114. ***For smaller institutions, we have recently introduced our "Performance Insight" service which is an affordable profitability measurement system designed specifically for you.***

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, process improvement or financial advisory services, please call us at (973) 299-0300 or visit us at www.kafafiangroup.com.

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