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Feeling the squeeze

Low interest rates and more regulation are making it tough on banks. Look for a wave of consolidation.

By Jerry Reimenschneider
Reading Eagle

Interest rates remain down – way down. So does loan demand.

Regulations are up. So are compliance costs.

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All of which swirls together into a relatively obvious truth: It's a pretty tough time for most

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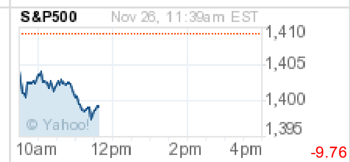
S&P 500	1399.39		-9.76
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"It is," agreed Dave Roland, Susquehanna Bank's regional president for the Berks/Lehigh Valley. "Though I would use the term challenging. In the times of the 'go-go' markets, the challenge was to keep up. Now, because of the economy, it's just different challenges for a different day."

But Robert E. Kafafian, president and CEO of the financial-consultant firm The Kafafian Group Inc., said the situation is dire.

"There are a lot of banks right now that are just treading water," he said. "They're just kind of waiting for a better day."

Richard A. Ehst, president and chief operating officer of Wyomissing-based Customers Bank, is hardly treading water at his innovative outfit. But he concurred with Kafafian on banking's general condition.

"The biggest issue our industry faces is trying to find opportunities in this rather troublesome environment," Ehst said.

Customers has done a pretty good job of discovering such openings. The technology-first bank, which has four Berks branches, enjoyed a nearly 220 percent boom in deposits from June 2011 to June 2012. Based less on brick-and-mortar locations and more on cyberservice, Customers realizes cost efficiencies that drive down expenses and drive up appeal to depositors and borrowers.

Other banks approach these trying times in other ways, some successful and some not. But bankers in Berks County and beyond do come to a consensus on several industry trends and challenges.

The rate squeeze

Generating just about every current difficulty are continuing, razor-thin interest rates.

"The extended period of low rates really puts a lot of pressure on banks," said Lewis Cyr, president of National Penn Bank's Central Region.

That's putting it mildly, Kafafian said.

"Banks are getting crushed by these low interest rates," he said.

Banks make most of their money on what's called the spread: the difference between their income on lending instruments and their payment on deposits and other borrowed funds.

"And the profit margins have been squeezed out of the spread," Kafafian said. "You can't drop the rate below zero, and we're next to zero, and so you're getting squeezed into the floor."

While rates are clearly attractive to individual and corporate borrowers, their confidence levels and cash flows remain modest. This compounds the problem in a perfect-storm sort of way, lowering borrowing amid low rates.

"There's not enough loan demand to feed all the banks," said Eric Warfel, senior vice president and area manager of Metro Bank. "So what's happened in the last couple of years, because there hasn't been the loan growth that we had hoped, there's less of a need to gather deposits."

Even if banks had greater deposits needs, customers, due again to the low-rate ripple-down, have little incentive to put their money into traditionally safe accounts with once-decent yields. And banks, minus borrowing demand, turn to their own skinny-yield investments: bonds,

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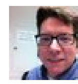

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overnight funds and the like – hardly significant moneymakers.

When institutions do win a multibank fight to lend money, it's rarely a windfall.

"The impact of that competition (to lend) is that it's pushing down the yields," Kafafian said. "So they're not even getting the prices that they used to from that."

Another albatross

Discuss today's industry issues with any banker for five minutes and rising regulation will rear its pricey head.

"The regulatory environment has been more burdensome, and (it's) definitely more costly for banks to comply," said Metro's Warfel, echoing everyone interviewed for this article.

Most executives tab the controversial Dodd-Frank Act of 2010 as the chief culprit. Regardless of where culpability lies, the cost consequences are real, Kafafian said, and represent more than the standard industry whining.

"Oh, clearly," he said. "The burden is significant. We have clients spending more time dealing with regulatory compliance than they are in dealing with customers right now, which means they're not doing anything productive.

"And the smaller the bank, the bigger the burden."

Customers' Ehst elaborated.

"Any company that is under a billion dollars (in assets) is going to have difficulty surviving in the new world order," he said. "With extreme compliance requirements, extreme pressure on margins, it's going to be very difficult for banks under a billion dollars to make a go of it."

The merging tide

Warfel, who oversees Metro's five Berks branches, surveys the banking landscape and sees bundles of largely unprofitable cash on hand and an excess of capacity.

"There are lots of banks in the marketplace," he said. "Some people would call it overbanked."

Which cycles us back to Ehst's observations about subbillion-dollar banks.

The rising regulations, the lowering rates and the dropping borrowing demand create a ripe consolidation environment.

"I think that will inspire a lot of merger-and-acquisition activity in the near future," Ehst said.

"There's going to be continued consolidation, particularly with community banks," Warfel said. "Not just in this market, but nationally."

National Penn's Cyr expects his thriving bank to be a buyer in upcoming mergers. From the late 1990s to 2008, National Penn had acquired more than 15 banks, insurance companies and other affiliates. Since acquiring KNBT four years ago, it has taken a merger breather while it invests its ample capital in growth and infrastructure.

But Cyr said the bank, which had $1.32 billion of deposits as of June, isn't finished consolidating.

"We feel, based on our financial strength, we're an acquirer of choice," he said, "and we hope we can participate as the industry consolidates."

And consolidate it certainly will, Kafafian agreed. He noted that fewer than half of the financial institutions that existed a quarter-century ago survive, a financial phenomenon that occurred through both bad times and boons.

"We're in a consolidating industry," he said. "Regardless of what happens, there will continue to be mergers. The real question is whether it will be accelerated because of the trouble these community banks are facing, and that could very well be the case."

Consolidation's cost efficiencies simply are too pronounced to stem the merger tide, particularly now.

Technology's role

There are other ways to streamline costs while better serving customers, and technology is chief among them.

At varying speeds, virtually all banks are integrating online tools and smartphone apps into their systems. Doing so serves two functions: It increases efficiency, and it builds a service bridge from older to younger customers.

"Kids, if they're not on their iPhone, they're not interested," said Susquehanna's Roland, whose area includes Berks' nine branches. "They work harder to try to do it online than they would to walk into a bank and try to bank with a human being."

Newer software also, handles a lot of formerly labor-intensive tasks: credit management, file building and file keeping, and some regulatory lending functions.

"A lot of that's been automated," Roland said. "So it lowers the need to increase staffing, and makes the existing staff in the branches much more efficient. They can concentrate more on the customers."

Customers Bank has been a local leader in embracing online banking, a main factor in its major growth; Customers' deposits are up to $4.67 billion, more than three times its 2011 Federal Deposit Insurance Corp. number.

"Many customers under the age of 45 seldom set foot in a banking office," Ehst said. "They carry that office around in their pocket. It's called their iPhone."

Harrisburg-based Metro is on its way to the party, too. It has a Facebook page and Twitter handle now, and is on the verge of launching its new mobile banking applications.

Competitive coping

There are notable local success stories amid this banking storm.

Young Customers Bank has boomed. It draws customers with low costs and appealing technological tools. It is thriving in its lending by being both innovative and predatory. "We survive by stealing business from other banks," Ehst said, "because the markets are not expanding."

When National Penn's Cyr heard the list of negatives this article would highlight, he chuckled knowingly.

"Not to turn it into a National Penn commercial, but we're in a much healthier place (than the norm)," Cyr said.

National Penn has dramatically raised capital and earnings over the past two years, and is investing in four new regional office buildings that will streamline administrative costs and functions. One of those new centers will stand at the intersection of Papermill and

Broadcasting roads in Spring Township.

Over at Susquehanna Bank, Roland said innovative instruments help retain customers in lieu of attractive interest rates.

"We structure something based on their priorities, not our priorities," Roland said. "It's been successful for the most part."

Still, Kafafian said, such stories are exceptions that prove the rule. Most banks continue, to repeat his phrase, to tread water and wait for that better day.

"And the better day would come in two ways: With the economy turning around with real economic growth, and if interest rates rise to the normal levels," he said.

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There's money in these vaults

The 10 banks with branches in Berks County with the largest dollar deposits, ranked in order and based on the figures the Federal Deposit Insurance Corp. released in October.

Bank (number of Berks County branches)	2012 deposits* (millions)	2011 deposits* (millions)	% change
Sovereign Bank (12)	$1,950.4	$2,741.2	-28.85
Wells Fargo Bank (18)	$1,512.1	$1,174.3	+28.76
National Penn Bank (19)	$1,317.8	$1,306.5	+0.86
VIST Bank (15)	$753.3	$688.4	+9.43
M&T Bank (14)	$549.9	$556.5	-1.20
Customers Bank (4)**	$466.5	$146.1	+219.30
Fulton Bank (10)	$413.1	$442.0	-6.54
Susquehanna Bank (9)	$391.3	$388.1	+0.83
Citizens Bank of Pennsylvania (11)	$370.7	$383.8	-3.42
Fleetwood Bank (6)	$199.6	$185.6	+7.56

* Deposit figures as of June 30 for the year listed ** Acquired Berkshire Bank in September 2011

Source: Federal Deposit Insurance Corp.

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