FMS Update

MARCH 22, 2016

Hanging in the Balance

A panel of experts tackles the tough balance sheet questions facing community institutions

THE Federal Reserve may have finally gotten the ball rolling late last year with its first interest rate increase in years, but anyone anticipating a clearer, more predictable path going forward was likely nevertheless disappointed. Community institutions today face just as many questions and uncertainties with respect to their balance sheets as they did before the long-awaited rate move, but regardless of what the Fed does or doesn't do going forward there are still decisions to be made, questions to be answered and strategies to be calibrated in the meantime.

Are we appropriately positioned for the current environment? How can we boost our net interest margin? Where should we be looking in our investment portfolio? Are we pricing our loans and deposits correctly?

FMS took these issues to six experts in the field to get their take on what's happening – and, in some cases, what should be happening – on the balance sheets of community institutions. This is the first in a two-part compilation of their edited responses – you'll find the second half of the roundtable in the April 5th issue of *FMS Update*.

What should be the number one concern for most community institutions with respect to their balance sheets in the current environment?

David Sweeney: The continued low-rate environment and flattening yield curve will impact the repricing of loans made years ago, therefore reducing loan yields and net interest income. For example, in the first half of 2011, the 5-year swap rate averaged 2.20% – those 5-year loans are now coming due and will be repricing at the current 5-year swap rate of 1.33%. Accordingly, institutions rolling over 5-year loan relationships will be seeing a sharp decline in yields, without an offsetting decline in interest expense.

Charles McQueen: I think matching yields to the risk they're putting on their books is probably the top concern for institutions right now. For example, if you look at what's going on today with indirect car lending, you'll find people putting on 10-year car loans at

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Coming Clean on Overdraft

Institutions work to shift customer, regulator perceptions

FOR the most part, it's hard to find anybody outside of the banking industry with something nice to say about overdraft protection.

With the Consumer Financial Protection Bureau (CFPB) long beating the drum for some type of reform, most takes on the topic continue to run along the lines of a recent *New York Times* article focusing on consumers racking up big charges while banks laugh all the way to, well, themselves with a pile of big fees.

While few institutions will dispute the notion that overdraft does, in fact, represent a solid (if not spectacular) source of noninterest income in an environment where every such dollar matters, recent data suggests that the service

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In this Issue

FMS Quick Poll: Technology in the Boardroom

COMMUNITY institutions have seen firsthand just how rapidly the industry has moved toward technology-based paperless solutions and practices over the past several years. In light of this, perhaps the results of our latest FMS Quick Poll on technology in the boardroom will come as no surprise.

Asked whether their boards of directors receive hard copies of board meeting materials, 78% of the nearly 200 respondents said they have moved either entirely or partially away from print, and 81% noted that their entire board package is distributed electronically at this point (while another 11% plan to make the switch to all-electronic in 2016). Further, 67% of poll participants said they are now supplying their board members with tablets or other devices to be used specifically for board-related meetings.

Does your institution distribute the entire board package electronically?			
	All Responses	**Banks**	**Credit Unions**
Yes	81%	81%	83%
No, only partially	4%	4%	0%
No, not at all	4%	4%	4%
No, but plan to do so in 2016	11%	11%	13%

At $686-million SussexBank in Rockaway, N.J., CFO Steven Fusco says the board is already on its second technology solution for meeting materials (Diligent Boardbooks) after five years using another platform. While board members were still often printing out their packages under the previous system, Fusco says the upgrade to Diligent has pushed almost everything exclusively to paperless, and the board seems not only very happy but even more invested in the proceedings.

> *The meetings definitely run more smoothly, since board members are no longer shuffling through papers. There is a much better flow that makes everyone more efficient.*
>
> *Steven Fusco, CFO, SussexBank*

"The meetings definitely run more smoothly, since board members are no longer shuffling through papers," Fusco says. "Board members find the technology easy to use, and they're often more prepared and more engaged in the meetings. There is a much better flow that makes everyone more efficient."

Despite that prospect of greater efficiency, some FMS member institutions have yet to make the transition to electronic board materials, or are simply doing so at a more measured pace. With a mixed board comprised of both newer members who like to use their tablets during meetings and older holdouts who still prefer paper at $396-million Phoenixville Federal Bank & Trust in Phoenixville, Penn., EVP and CFO John Carrozza so far hasn't seen a compelling reason to move beyond the partial plan (financials are electronic) currently in place.

"At this point, the cost of the software outweighs the benefits since we still have older board members who simply like the paper," he says. "Still, I think over the next two to three years we will transition to all-electronic board materials."

Indeed, while the trends were fairly consistent across both banks and credit unions, there was perhaps not surprisingly some divergence to be found across asset sizes, likely due in part to the costs associated with a new technology outlay. For example, while 84% of respondents above $1 billion in assets indicated that they are supplying their board members with tablets, just 50% of those at or below the $250 million mark are doing likewise.

The full results of the Quick Poll are now available at www.fmsperspectives.com. ■

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offers as much of a benefit to the consumers who use it as it does to the institutions that provide it. Even the CFPB may be considering a change of heart on overdraft, having removed it as a line item from its most recent list of regulatory priorities for 2016.

So how should community institutions view their overdraft programs in the current environment? Has the storm mostly passed, or is this merely a pause in the march toward the ultimate, inevitable demise of overdraft?

Staying Power

Jeffrey Harper, President of BSG Financial Group in Louisville, Ky., believes that despite all of the uncertainty surrounding them, there are a number of reasons why institutions should not abandon discretionary overdraft programs at this point.

"Consumers still have short-term liquidity needs, and many of those needs are being met by these discretionary overdraft programs," Harper explains. "A lot of overdrafts are only outstanding between five and ten business days, so there is a need for short-term liquidity and community banks and credit unions are the best places to fill that need, either through a loan or an overdraft."

For those institutions opting to maintain a formal overdraft program, Harper says all of the regulatory attention these days means that rigorous attention to proper procedures and correct reporting should be an essential piece of the puzzle.

"It's more important than ever to be able to track things like who's overdrawing, the fees being paid for overdraft and the repayment capacity ratio – which is fees paid for overdraft divided by the amount of deposits made by that customer," Harper says. "A lot of institutions don't really know where overdrafts are being created, so a formal overdraft solution should be able to identify where those are occurring. This helps create a better service, but also shows regulators that the institution knows where its customers' needs are for short-term liquidity and how it's meeting them."

Focus on Service

Harper believes that the key for institutions trying to change both regulator and consumer perceptions is to treat overdraft programs as the much-needed service that they are, and not just a fee-generating exercise.

"I think it's a pretty common mistake on the consumer side to not focus on overdraft service as a line of business," he says. "It's a line item that creates money for the institution, but they're not really focusing on it from a service perspective. A lot of times consumers will see the opt-in/opt-out decision as little more than the fee, and they'll likely opt out because of that. They don't see overdraft as a service, because the institution doesn't really present it as such – it's more of a penalty to be avoided."

One way that institutions may be moving in the right direction on this front is by transitioning from one-size-fits-all fixed-limit overdraft program to more of a dynamic-limit approach, where overdraft limits are set by multiple different attributes, such as deposits, frequency of deposits, deposit dollar amounts or length of relationship with the institution. Harper believes that this type of shift to a more automated, consistent and service-focused decision is a step in the right direction.

"More institutions should be moving toward the dynamic-limit approach, and treating customers as individuals rather than 'product types.'"

Regulatory Concerns

While more institutions may be moving toward these types of customer-focused changes to their overdraft programs, there remains concern throughout the industry that these efforts may be for naught if the CFPB renews its call for a major overdraft overhaul. Harper, however, believes that any eventual regulatory intervention will likely be focused on tweaking current practices rather than doing away with overdraft altogether.

"As long as there are institutions, checking accounts and humans, there are going to be overdrafts," he says. "So overdraft isn't going to go away, but what may come to pass is some type of cap on the fees that can be charged on an annual basis. The regulators may also try to focus on alternative products. For example, if you have a customer who has had a certain number of overdrafts in a 12-month period, what other affordable solutions can you offer to that person?"

The determining factor in the CFPB's decision may ultimately be the agency's increased awareness about who exactly is using overdraft programs and why, as laid out in a number of recent studies.

"We're hearing something may come down in late 2017, but what we think is that the CFPB is getting more data and understanding who the overdraft users really are," Harper says. "It's not necessarily the poor, as many people assumed for a long time. The data shows that people who overdraft ten or more times in a given period are folks who average over $8,000 a month in deposits. They don't have a higher collective balance but they deposit more, so it's all about cash flow and the lifestyle that overdrafters live. They're paying for the convenience value of their money." ■

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extremely low yields in the 3% to 4% range. There's negative equity in these loans, and I think in many cases there's not the proper risk adjusting going on. Usually the response we'll hear is 'well, everyone else is doing this, so we have to compete at these rates.' So I think risk-adjusted return is the big thing to watch out for.

Todd Cuppia: To provide some context to the recent flattening of the front end of the yield curve, the interest rate spread between the 5-year swap rate and 1-month LIBOR has essentially been cut in half over the course of the last three quarters, narrowing nearly 80 basis points since the second half of 2015. For reference, the spread has averaged 135 basis points over the course of the last 25 years, leaving today's 82 basis-point yield spread in the 35th percentile in historical context. To make matters worse for management teams, the implied forward curve is pricing in an additional 30 basis points of curve flattening in the coming years. This highlights the need for financial institutions to use every tool available to actively manage each incremental basis point of income or expense. While many management teams have done well to rationalize pricing in many areas of the institution for the current environment, there are still meaningful efficiencies that can be gained by optimizing the institution's wholesale funding and investment strategies to help mitigate the impact of a flattening curve.

Michael Davis: The main concern should be preserving or maintaining their margins and accompanying balance sheets. This includes finding the next round of loan growth, priced appropriately, and the optimal mix of corresponding funding. Our clients have recently lowered their expectations for loan growth over the balance of 2016 – couple this with a relatively flat yield curve pressuring margins, and institutions may feel forced to relax credit standards or pay up for local loans/deposits. We suggest institutions think differently – if the local market is not conducive to quality, organic loan production, consider secondary loan packages with adequate return and solid or desired credit and interest rate risk profiles. On the funding side, banks have largely reduced wholesale funding since the crisis, leaving ample borrowing capacity. Assuming an absence of low-yield, short-term asset-based liquidity, with the curve flattening this may be a good time to lock in low-cost funding.

Greg Garcia: In the current environment, we still expect to see net interest margin compression with earning-asset yields continuing to decline. A lot of loans put on five years ago are coming up to their repricing periods, and a lot of our clients are seeing refinancing and new loans put on at lower yields than their predecessors. With the recent decline in the 10-year Treasury rates, we think we're going to continue to see margin compression in 2016 and probably into 2017. So that's probably the primary concern right now.

Bart Smith: I think the biggest concern is that community institutions are not structuring their balance sheets for current earnings. There is so much posturing for hypothetical rate scenarios that institutions leave millions on the table as they wait for higher interest rates. Clearly, we are in a historically low-rate environment and the risk of rates going up is very real. However, the risk of a prolonged low-rate environment is also very real and maybe even more likely. Institutions need to plan for success in all reasonable rate scenarios and ensure that their policy parameters and risk tolerances are appropriately considering the full range of risks

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The Balance Sheet Roundtable

Todd Cuppia
Director of Balance Sheet Strategies
Chatham Financial

Greg Garcia
Senior Managing Director
FinPro, Inc.

Bart Smith
Managing Director
Performance Trust Capital Partners, LLC

Michael Davis
Director of Strategies
SunTrust Robinson Humphrey

Charles McQueen
President
McQueen Financial Advisors

David Sweeney
Managing Director
Chatham Investment Advisors

What's happening on your balance sheet? Do you agree or disagree with what our experts are seeing? Share your experiences today on FMS Connect or email us at markl@fmsinc.org.

that are present. Overprotective risk strategies almost always lead to weaker earnings and less capital accretion, which can actually increase the institution's overall risk posture over time.

Where do you see the best opportunities for increasing net interest margin in the coming years?

Sweeney: If the institution has excess liquidity on the balance sheet and views the current low-rate environment as one that will stick around for a few more years, now may be the time to further test how low it can move deposit rates PLUS lending fixed rates for terms over five years and/or buying longer-duration securities.

McQueen: The main thing to focus on here is having a diversified lending portfolio. Most balance sheets are too short and too fearful of rising interest rates. People are so worried about rates rising when they should be focused instead on maximizing their net interest margin in any rate cycle, and not trying to maximize it for the opportunity of rising rates. So I think there's an opportunity to put a few more longer-term loans on the books, but really the key should be a diversified holding of numerous loan types and investment types to get the correct duration and to make sure income is as high as possible.

Cuppia: This is the $64,000 question facing our business, and there is no easy answer. The industry, in the aggregate, has already picked much of the low-hanging fruit. Securities as a percentage of total assets have fallen back to a 20-year low, entirely reversing the marginal increase that took place following the credit crisis. Currently, banks and thrifts with less than $10 billion in assets are holding around 18% of total assets in the bond portfolio, down from 30% in the 1990s. This dynamic leaves little room for margin expansion from reshuffling the allocation from bonds to loans or through a yield/liquidity trade-off in the bond portfolio. At the same time, data from the FDIC indicates that long-term assets (5+ years) as a percentage of earning assets at insured depository institutions is the highest that ratio has been since the time series began in 1996. To combat the long-term secular decline in net interest margins, many banks increased the amount of interest rate risk embedded in their balance sheets, which also leaves management teams with little room for margin expansion from asset allocation or by increasing the target for asset duration. In this difficult and hypercompetitive operating environment, we continue to see the best opportunities to expand margin in strategies that wring every basis point of savings of out of wholesale funding sources, which can be meaningful and are often overlooked by management teams.

Davis: Many of our bank clients have shifted to an asset-sensitive position hoping for a higher rate environment to expand the margin. While the Fed increased the benchmark rate at the December meeting, expectations are for just one or two more rate hikes this year. Additionally, the longer end of the curve has fallen since the Fed meeting, further pressuring margins. Over the next few years, just maintaining margins could be a challenge should the current rate environment persist. Replacing excess short-term, low-yielding liquidity with quality loans (via the secondary market if necessary) or well-structured investments is a basic starting point to combat ongoing margin pressures. Absent asset-based liquidity, the prudent use of wholesale funding may provide a beneficial, low-cost mechanism to fund available spread assets.

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>
> *Bart Smith, Managing Director, Performance Trust Capital Partners, LLC*

Garcia: Institutions need to continue to focus on loan growth, and shifting their balance sheets to more loans. One way to try and offset some of this is to replace lower-yielding investments with higher-yielding loans. I think the institutions that can lend are the ones that are going to win, not necessarily by widely expanding their net interest margin, but just by maintaining. On the liability side, there's not really a lot of room left. Most deposit pricing has kind of bottomed out. M&A is another part of it, where we're seeing institutions that can lend and have really strong pipelines actually looking to acquire

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Soft Close

Fourth quarter continues pattern of slow, steady growth for community institutions

AFTER a prolonged period of drama and tumult, community institutions can be forgiven for welcoming the relative boredom of the past several quarters. Even with tight net interest margins challenging them at every turn and continued uncertainty with respect to interest rates, a slow and steady pattern of growth has been far more appealing than the alternative, and the fourth quarter of 2015 did its part to keep the quiet rally going.

According to the FDIC's Quarterly Banking Profile, community banks reported earnings of $5.1 billion during the fourth quarter – an increase of 4% from a year earlier – and 57% of community banks reported an increase in earnings from the fourth quarter of 2014. The FDIC noted that net interest income (up 6.5%) and noninterest income (up 10.8%) were largely responsible for the earnings growth, while higher loan-loss provisions and noninterest expenses (up 5.7%) worked to hold down larger gains.

Despite the good news on the revenue front, however, net interest margin again proved a stubborn beast to tame. For yet another quarter, community banks saw a slight slip in NIM to 3.6%, down three basis points from the previous year. On the bright side, community banks again enjoyed a slightly better quarter in this regard than their non-community brethren, with a 55-basis-point advantage in NIM for the period.

Loan growth continued apace at 2.5% in the fourth quarter of 2015, with loans and leases representing 67.8% of total assets at community banks, the highest level since late 2009.

Meanwhile, assets and deposits were both on the rise at the nation's credit unions to close out 2015, according to the NCUA. Total assets rose to $1.2 trillion at the end of 2015, an increase of 7.3% from the end of 2014, while deposits saw a 6.9% jump to top $1 trillion. Lending continued to drive the growth at credit unions, with an increase of 2.3% in total loans over the previous quarter, and 10.5% from the prior year, as auto loans again lead the way. Credit union membership crept to a new high of 102.7 million, but consolidation across the industry resulted in 252 fewer credit unions at the end of the fourth quarter compared to a year earlier, a drop of 4%.

The full FDIC quarterly profile for community banks is available at https://www.fdic.gov/bank/analytical/qbp/2015dec/qbpall.html, and the NCUA release can be found at https://www.ncua.gov/newsroom/Pages/news-2016-march-call-report-data.aspx. ■

Regulatory and Accounting Proposals

An expanded list of proposals may be accessed through the FMS website at www.fmsinc.org. Go to the Resource Center on the home page and follow the Regulatory Proposals link for the expanded list and direct access to the cited documents.

FASB > Statement of Cash Flows
A proposed accounting standards update addresses eight specific cash flow issues with the goal of reducing the existing diversity in practice, and would apply to all entities that are required to present a statement of cash flows under Topic 230. *Comments Due March 29, 2016.*

FASB > Compensation—Retirement Benefits
Two accounting standards updates intend to improve financial reporting by employers related to defined benefit pension and other postretirement benefit plans. *Comments Due April 25, 2016.*

Fed > Federal Reserve Bank Capital Stock
The Fed issued an interim final rule that amends procedures for payment of dividends by the Federal Reserve Banks to implement the provisions of "FAST". The rule sets out the dividend rates applicable to Reserve Bank depository institution stockholders and amends provisions regarding treatment of accrued dividends when a Reserve Bank issues or cancels capital stock. *Comments Due April 29, 2016.*

Fed, FDIC, OCC > The 18-Month Examination Cycle
Federal banking agencies increased the number of small banks and savings associations eligible for an 18-month examination cycle rather than a 12-month cycle. Under the interim final rules, qualifying well-capitalized and well-managed banks and savings associations with less than $1 billion in total assets may now be eligible for an 18-month examination cycle. *Comments Due TBD.*

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deposit-generating institutions. I think we'll see more of this type of activity throughout 2016 and 2017.

Smith: To increase margin, I think community institutions need to take an honest look at the composition of their earning assets. In their most simplistic form, earning assets are comprised of core and non-core asset groups. Core assets include the primary loans and relationships that go to the most loyal and profitable customers. These assets provide the highest and most stable returns and generally have net yields that exceed a company's target ROE. Non-core assets include loans and securities that extend beyond the core asset base. While generally lower yielding, when managed properly this part of the balance sheet can create a real boost to net interest margin and generate differentiating returns to net income.

Given the above, I believe it's critically important that management understand and intentionally manage non-core asset allocations. Too often, community institutions will over-concentrate in familiar loan categories, which are core in the sense of product or collateral type, but very much non-core in the sense of pricing and/or terms. In other words, they underprice and/or under-protect themselves in a known space instead of exploring less familiar spaces that can offer a better risk-reward trade-off. Exploring and deploying alternative asset opportunities through a comprehensive and thoughtful balance sheet strategy can actually improve overall profitability and reduce risk.

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>
> *Todd Cuppia, Director of Balance Sheet Strategies, Chatham Financial*

***Be sure to catch part two of the balance sheet roundtable as our experts discuss investment portfolio possibilities and loan and deposit pricing in the April 5th issue of* FMS Update.** ■

What Do You Need to Prepare for CECL?

Upcoming FMS programs focus on impending standard

IF THERE'S one thing that is certain with regard to FASB's proposed Current Expected Credit Loss model (CECL), it's that everything seems uncertain. But that doesn't mean that you can't take the time now to prepare for what's to come.

FMS has you covered with our **Prepare for CECL** seminar. Designed to help you become familiar with what you and your institution can expect in the future, this comprehensive program will detail what we do know and guide you through what you can do now to prepare for these upcoming changes.

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With three opportunities to attend, each two-day seminar is presented by longtime FMS speaker **Mike Umscheid**, President and CEO of ARCSys and a subject matter expert in allowance accounting. Mike will provide a basic introduction to CECL, dig deeper into exactly what is changing with respect to how institutions classify and measure assets, and close things out with a detailed discussion of the new disclosures you need to be aware of.

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FMS Financial Managers Society
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FMS Education Calendar

Seminars

Atlanta, GA

March 31-April 1 Prepare for CECL

Orlando, FL

April 19-20 FDICIA: Pragmatic Solutions

April 21-22 Internal Audit Credit and Lending Operations

Indianapolis, IN

May 3-4 Enhancing Your ALM Modeling Process

Financial Managers School

May 9-13 Amherst, MA

September 18-23 Madison, WI

Annual Conference

June 12-14 The 2016 Finance and Accounting Forum for Financial Institutions

Calendar is subject to revision when program changes occur. For details, visit http://www.fmsinc.org/FMSEvents or call (800) ASK-4FMS (800-275-4367).

FMS Update

FMS Update is published biweekly by
Financial Managers Society, Inc.
1 North LaSalle Street, Suite 3100
Chicago, IL 60602
312-578-1300
info@fmsinc.org

Editor: Mark Loehrke
markl@fmsinc.org, 312-630-3421

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