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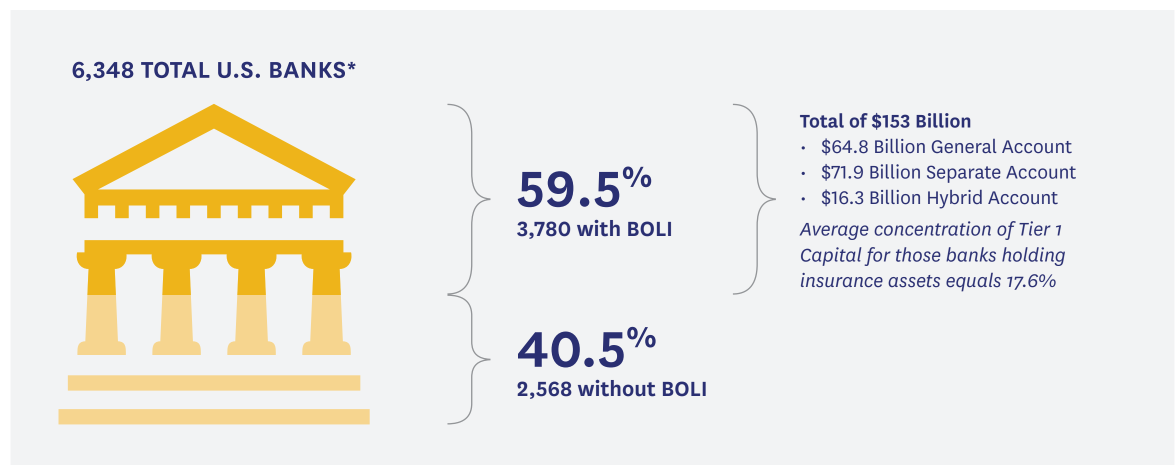
The VAULT

The BOLI Blurb: Statistics



A Banker's View

by Mark Cvrkel, Senior Bank Consultant at The Galbreath Group

The Changing Banking Landscape will Require Community Banks to Refocus

"What if we don't change at all… and something magical just happens?"

It will be a necessity for community banks to make a conscious effort to change the business as usual strategy if they plan on both remaining independent and providing an adequate return to their shareholders. The banking industry continues to face headwinds driven by increased competition, regional acquisitions, and continued regulatory constraints. The majority of banks have totally exhausted the release of provisioning, wrung out the last of the cost savings, and addressed most of the regulatory burden as it relates to anti-money laundering (AML) law and Bank Secrecy Act (BSA) compliance. It should be noted that we are observing the sixth anniversary of banks projecting market rates to increase. With the 10-year trading between 1.99% and 2.36% over the past month (2.36% representing the high since the July 2015 timeframe impacted by the strong employment number reported on November 6th), and the Fed continuing to maintain its zero market rate stance, maybe a different perspective on banks' management of the balance sheet must be contemplated. It should be noted that the market and most economists are now predicting a 25 basis point (bp) Fed move at their next scheduled meeting on December 15th and 16th. As of November 13th, the market is giving a 66% probability of a December rate increase.

*Source: FDIC Call Report Summary Report, 6/30/15

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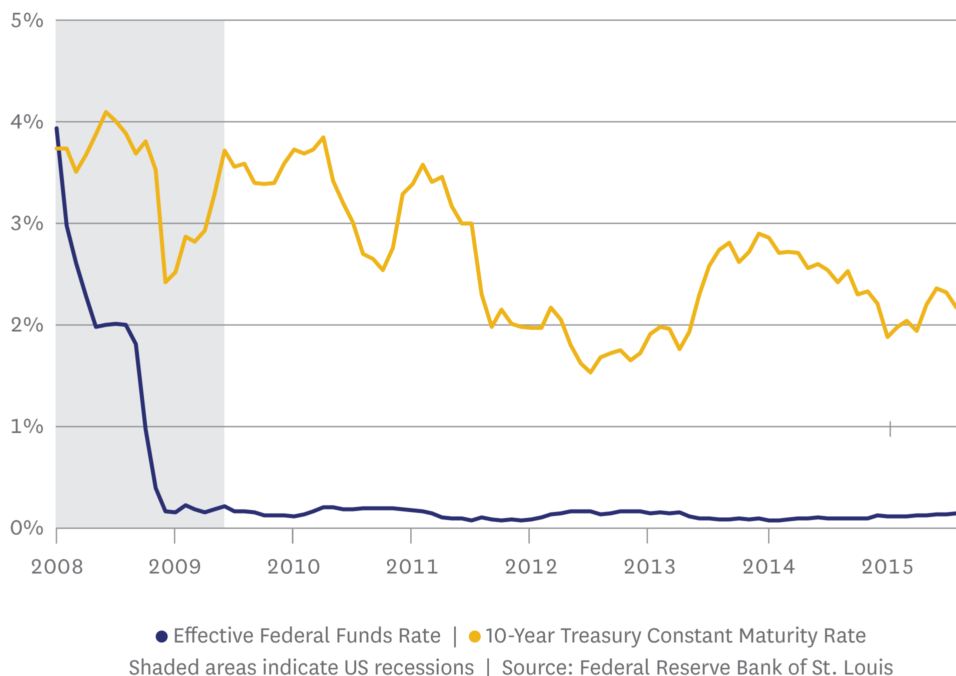
I have always heard that there are two types of economists when it comes to forecasting interest rates, "those who don't know, and those who don't know that they don't know." One can conclude that economic numbers coming out of the United States have been positive over the past few months, especially the most recent 271,000 jobs number. On the other hand, international concerns including initiatives by other central banks to lower rates and devalue currencies along with uncertainty out of China continue to be a potential cause of angst. Who really knows how accurate their "manipulated" numbers are? The current forecasted growth rate via Goldman Sachs for 2016 is 6.4%. Chairperson Yellen continues her dovish stance, hesitant to start any tightening. However, with the noted data dependent driver, be prepared for a 25 bp increase in the targeted funds rate. In my opinion, a 25 bp rate hike would do nothing except remove some volatility in the markets. I do not anticipate any substantial move in rates (as was the case during those inflation years a few decades back), so perhaps we may actually get on board with a measured approach in defining a rate increase. If this is the case, a lot of community banks' balance sheets have not been sufficiently opportunistic regarding the amount of available positive carry. It would be prudent for banks to determine the cost of maintaining their long-term asset sensitivity position if they aren't doing so already. The opportunity cost of forgoing positive carry may be substantial, especially with a measured approached for increasing market rates.



Shaded areas indicate US recessions | Source: Federal Reserve Bank of St. Louis

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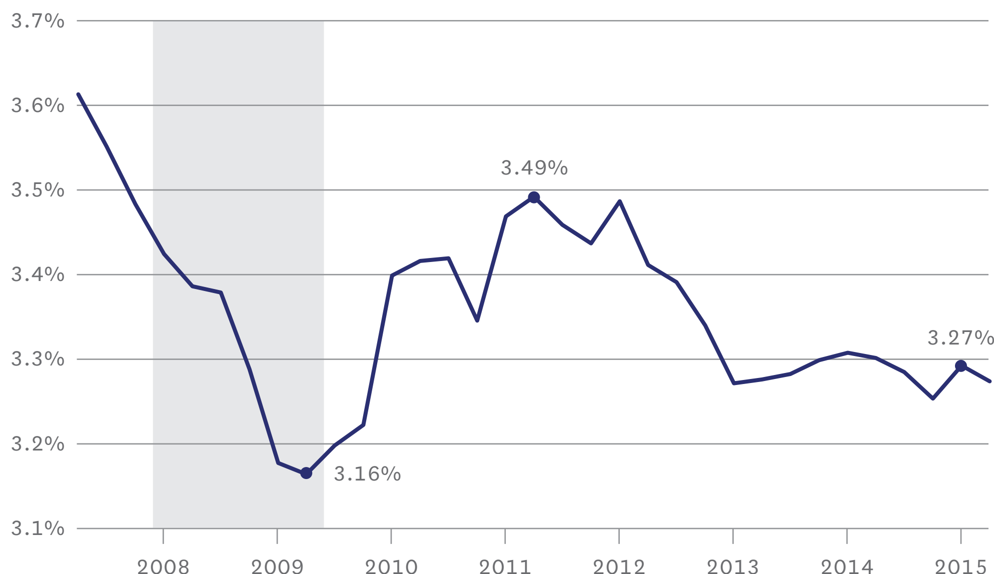

Over the past few months, I have looked at quite a few banks. Some are strong performers, and some need improvement, having what I like to call "Pain Points." In my review of mainly community banks, I have found some common issues:

- Net interest margin is declining, and spread income is under tremendous pressure.
- Branch networks are underperforming relative to deposit growth and capturing market share.
- Banks continue to structure their balance sheets for a rate increase, giving up a tremendous amount of positive carry.

Net interest margin has been the lifeblood of banking since the inception of the industry. Banks that make the decision to prosper in this competitive and regulated industry must find ways to diversify income streams beyond the traditional channels employed in the past and should consider developing a wealth management product, with the goal of exceeding peer performance in noninterest income and striving to maintain and improve efficiency ratio. A model to explore is a white label wealth management product that could be implemented at minimal cost and be almost immediately accretive. Integrating this product into the banks' available offerings can generate after-tax margins in the 25% to 30% range, providing a huge customer retention factor. Community banks can also efficiently offer treasury-related products through a third-party provider, which will create additional fee income, balance sheet flexibility, and a framework for loan pricing. The loan pricing framework is perhaps the largest benefit that I did not anticipate when implementing a derivative sales strategy.

Margins will likely continue to narrow. This is influenced not only by the continued low-rate environment, but also by the increased competition of super regionals entering the community banking space. Recently in eastern Pennsylvania, BB&T became a new market competitor through the completion of the Susquehanna Bancshares acquisition and the announced acquisition of National Penn Bancshares. The entrance of BB&T into this market will bring a more structured relationship risk-based pricing framework, a wide range of product

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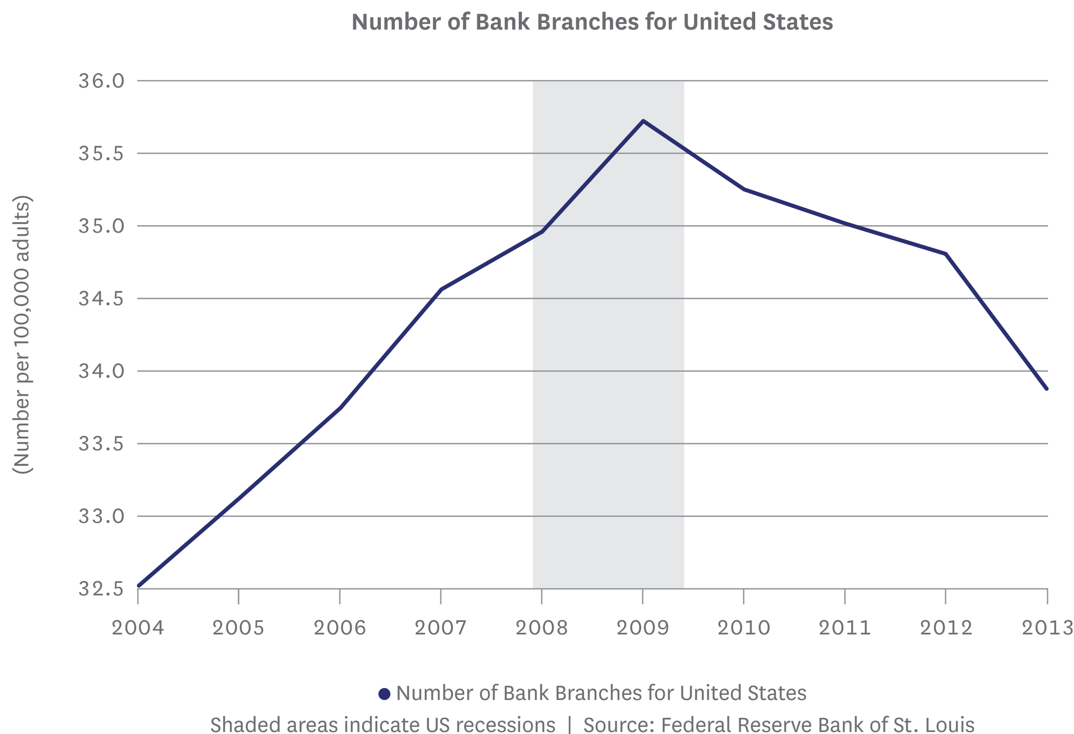

Shaded areas indicate US recessions | Source: Federal Reserve Bank of St. Louis

offerings, and increased mobile and online choices. Many smaller community banks are finding it difficult to compete. They must refocus in order to succeed.

The number of branches per 100,000 individuals peaked in 2009 at 35.7 with a steady decline since that time. A former superior of mine would have been happy with just one branch; his view was that "they are just expensive billboards." I don't know if I would go that far, but I understand his point. It is key to understand the role of your community branch network, the growth potential of the market area, and how this market can be captured. Given the low-interest-rate environment coupled with the growth of mobile banking, it is probably very challenging to achieve profitability at a branch with less than $50 million in deposits. A branch optimization strategy is critical in developing a branch network that supports the goals of the institution. Some banks do an outstanding job without a branch network. A good example of this is First Business Bank in Madison, Wisconsin. First Business is a $1.2B institution with a return on assets (ROA) of 143 basis points and a reported efficiency ratio in the 53% range.

Over the past few months while working at the Galbreath Group, I studied numerous community banks, focusing on opportunities and solutions to help improve performance and earnings and on how we as a firm may be able to add value either through offering a bank-owned life insurance (BOLI)-related product, evaluating BOLI account restructuring, or increasing the efficiency of board and management reporting, in addition to providing general banking expertise. Through this process, I noticed that several banks have a large portion of their investment portfolio in short-term, low-yielding assets. My assumption is that they are waiting for the Fed to finally increase rates.

Since this is included with The BOLI BLURB as a seciton of The Vault, I thought it would be appropriate to use the approximate fully taxable crediting rate as an example to illustrate the impact of positive carry and the related effect on banks' sensitivity position. See the actual bank example on the following page:

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	Average Balance ($000)	Yield/Cost (%)
ASSETS		
Short-term investments	100,000	0.25
Total Securities (FTE)	100,000	0.82
Total Loans & Leases	600,000	7.25
Total Earning Assets	**800,000**	**5.58**
LIABILITIES		
Total Interest Bearing Deps	600,000	0.88
Borrowed Money	40,000	3.94
Total Funding	**740,000**	**0.97**

Rate Sensitivity Analysis: If interest rates increase 200bps (2.0%) across all points of the yield curve, the base net interest income increases by 1.30%.

In this example, the base projected net interest income under static rates is approximately $38 million. Assuming a 1.3% increase resulting from a +200 basis point interest rate jump, this number would increase by $494,000. If the bank were to invest $10 million in BOLI with a current fully taxable yield of 4.75%, it would generate $450,000 of incremental income (net outcome of reducing short-term investments). The impact to the banks' sensitivity position would be minimal (1.3% to approximately 0.75%). There would be positive carry spread income of $250,000 ($450,000 less $200,000) in this scenario. This does not take into account that the crediting rate for BOLI does change. BOLI rates are not fixed and historically track the 10-year Treasury. In the base flat-rate model, the projected earnings per share (EPS) for this organization would increase by approximately $0.05, which would represent a 7% increase of base EPS.

In conclusion, I believe community banks must be nimble and creative in this changing landscape. They must form an opinion on a future rate perspective to effectively manage their balance sheets, and they must take advantage of positive carry when the opportunity presents itself. Manage short-term risks (interest rate, liquidity, capital, etc.), but always keep a long-term perspective.

The Galbreath Group, headquartered in Abington, PA, advises financial institutions and corporations on Bank-Owned Life Insurance (BOLI) and BOLI portfolio management, design, implementation, and administration of BOLI and COLI plans; analysis of current BOLI and COLI plans; strategic planning and compliance analysis; and design, implementation, and administration of non-qualified deferred compensation plans. Regardless of whether you are an existing client, we would be happy to address any questions or needs you may have.

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