Managing the Bank in World of Uncertainty

FMS Connecticut/Western Massachusetts Chapter

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- Dr. Clarke lectures on Asset/Liability Management & the ALCO process throughout the country. Jim performs interest risk audits and model validations for individual banks.
- Jim teaches at a number of national and regional banking schools.
- He is a frequent convention speaker, in 2014-2016 Jim spoke at the Connecticut, Maine and Pennsylvania Bankers conventions, the FMS Forum, COCC Members Forum, and the FMS Controllers Clinic, along with a number of directors conferences, including programs for Massachusetts and Maine Bankers Associations.
- Jim serves on the board of two community bank where he chairs the board ALCO, and Compensation Committee and is on the board of an investment company where he chairs the audit committee and is the lead independent director. Jim also serves on the editorial board of the RMA Journal responsible for reviewing articles on market and liquidity risk.
- Dr. Clarke has a B.A. from LaSalle College and a Ph.D. in Economics from the University of Notre Dame. He is a former professor in the Finance Department at Villanova University.

Agenda

- ❑Regulatory Focus
  - CRE
  - Liquidity
  - IRR
  - Are we going to get relief from the Trump administration?
- ❑Path for Interest Rates in 2017
- ❑Rising Rates and Deposits procing
- ❑Deposit Strategies in a Rising Rate Environment

Regulatory Focus in 2017

- **Commercial Real Estate Lending** – CRE lending and construction lending [including multi family] have been very strong in metropolitan markets [Boston Metro area in particular, but also Hartford]. **What is the regulatory concern?**
  - Rising credit risk on bank balance sheets as we approach the top of a business cycle.
  - Is CRE or multi-family at a saturation point: are developers over building? South Florida is experiencing saturation in high priced condo development: **could other areas be in trouble soon?**

Think of the Last Time We were at the Top of a Business Cycle – 2006/2007

- ❑ Loan demand was very strong ➔ similar to many markets today including Metro areas in the Northeast.
- ❑ Loan to asset and loan to deposit ratios were peaking – a little higher than current levels.
- ❑ **Attitudes around credit decisions were likely overly optimistic** ➔ With the strength of appraisals and borrower cash flows we can't make a bad loan.
- ❑ **Check non-performing loans in 2008 and 2009 – you can make a bad loan at the peak of cycles.**

Is there any chance of a recession in 2017 or 2018?

When is the current business cycle going to turn? Next Recession – 2017 [7% probability]/2018?

- ❑ **Current cycle, 7.9 years of expansion starting in the 3rd quarter 2009.**
- ❑ **Check out history's longest cycles: 1990s (#1), Viet Nam (#2), 1980s (was #3, now #4), and the current cycle (is currently #3). <u>Downturns happen in capitalist economies.</u>**

What happens when a cycle turns?

- ❑ **<u>Good loans</u>** become **<u>bad loans</u>**
- ❑ Understanding these historically verifiable factors, what do we do?
- ❑**But most important – when do we start to react?**

Regulatory Concerns: Liquidity

- ❑ As loan demand continues to increase balance sheet liquidity is decreasing. Examiners are concerned with the impact of rising rates & **surge deposits**.
- ❑ **What is sources of surge deposits?**
- o 2008 ➔ $2.5T moved from investment companies to banks (Due to safety of FDIC after financial crisis)
- o Customers have moved from certificates to MMDA and savings pools.
- o **As rate increase** ➔ what if they move back to MMMFs or what if they move back to certificates? What will it cost to prevent a surge back?

Trends in Liquidity

- At this point in a business cycle we should be avoiding liquidity risk.
- **Why are we taking liquidity risk**? Because interest rates have never been this low at this point in a business cycle – 1%. **Go check the 1990s expansion – Fed Funds at 6.50% in 1999.**
- In most business cycles the yield curve is flatter with less spread between short and long term rates. Therefore we are more willing to term out liabilities. Today it is very expensive to term out, so we are reducing liquidity and staying short.

Liquidity Cycle Tracks the Business Cycle

Peak 2007	Recession 2008	Trough – 2009	Expansion – 2017
High loan demand & strong asset quality.	Weak loan demand & asset quality problems	Weak loan demand – credit problems continue	**Strengthening loan demand & higher loan to asset ratios**
Low Liquidity due to loan funding	Cash increases – Call & Prepayment accelerate	Awash with cash in a low rate environment	**Banks are losing liquidity [this is happening] & asset funding is becoming more expensive**
High interest rates – flat yield curve	Short-term Rates drop quickly – steeper yield curve	Low Rates – steep yield curve	**Rates slowly increase – Yield Curve becomes flatter**

Regulatory Concern: Interest Rate Risk

With the Fed raising short-term interest rates, IRR will continue to be a focus in exams in 2017 & 2018.

Examiner concern is again with surge deposits.

- Pressure from MMMF [Fidelity] will occur in 2017
- Savers have moved from certificates to non-maturity deposits – savings & MMDA. Look at the pricing differential in your peer group:

➔ Savings accounts are paying 0.20%

➔ Certificates are paying 0.97%

What happens if savers move back?

Regulatory Relief Maybe in the near Future

Proposals to Amend or Repeal Dodd-Frank:

- Repeal is unlikely
- Amending Volcker Rule & Derivatives & Too Big to Fail: these proposals will have little impact on community banks.

Major changes to CFPB

- Stripping powers and enforcement would benefit community banks.
- Bring this agency under budgeting process

Bi-furcation is the most helpful approach – treat small banks and large banks differently.

Let’s give community banks real relief!

Community banks would benefit most from eliminating regulations based on activity or bank asset size:

- Look at Qualified Mortgage as an example: Banks under 2000 originations get exceptions.
- Apply the same logic to TRID and HMDA, and other regulations.
- Think of FDICIA threshold > $1 billion.
- Durban Amendment set a $10 billion threshold.
- Is CECL necessary for Banks under $2 billion? Is it really going to matter? Would it had made any difference pre-2008 crisis?

Interest Rate Environment

- Let's start with long-term rates which have increased significantly since November 7 (day before election).
- What does the forecast call for, both short-term and long term?
- What path is the Fed likely to take in 2017?
- What is the impact on the banking industry and your Bank?

Note & Bond Rates: Look at the volatility in 2016 and 2017

	2 Year	5 Year	10 year	2-5 Spread	2-10 Spread
December 2015	0.96%	1.71%	2.28%	0.75%	1.32%
March 2016	0.88%	1.38%	1.88%	0.50%	1.00%
June 2016 Pre Brexit	0.73%	1.17%	1.64%	0.44%	0.91%
July 2016 Post Brexit	0.61%	0.95%	1.37%	0.34%	0.76%
November 7, 2016 Pre US election	0.80%	1.24%	1.79%	0.44%	0.99%
November 28, 2016 Post US election	1.12%	1.83%	2.36%	0.71%	1.24%
April 2017	1.29%	1.92%	2.38%	0.62%	1.09%

Current Interest Rate Forecast – March 13

	1–2017	2-2017	3–2017	4–2017	1-2018	2-2018
Fed Funds	**1.00%**	**1.25%**	**1.25%**	**1.50%**	**1.50%**	**1.75%**
3 Month LIBOR	1.12%	1.38%	1.41%	1.65%	1.68%	1.88%
Prime Rate	4.00%	4.25%	4.25%	4.50%	4.50%	4.75%
Conventional Mort.	**4.22%**	**4.24%**	**4.26%**	**4.29%**	**4.31%**	**4.38%**
2 Year Note	**1.36%**	**1.72%**	**1.78%**	**1.99%**	**2.01%**	**2.22%**
5 year Note	**2.11%**	**2.19%**	**2.21%**	**2.35%**	**2.37%**	**2.48%**
10 Year Note	**2.50%**	**2.66%**	**2.70%**	**2.82%**	**2.84%**	**2.98%**
30 Year Bond	3.10%	3.18%	3.21%	3.29%	3.32%	3.40%
2-10 Year Spread	1.14%	0.94%	0.92%	0.83%	0.83%	0.77%

Path of Short-term Interest Rates?

All forecasts indicate a gradual change through 2017 into 2018: three 25 basis point changes in Fed Funds in 2017 is the current call. [**Maybe four after March increase**]

- This will depend on expectations of **economic growth**. If Congress can move on tax changes and infrastructure initiatives soon, **Fed will be more aggressive.**
- **Inflation:** there are signs that inflation is hitting Fed targets and there is reason to believe the inflation rate will increase: **This supports acceleration.**
- All signs indicate a rise in rates in 2017 – key is how aggressive Fed will become?

Impact of Economic & Interest Rates Forecasts

Asset Side of Balance Sheet:

- ❑ Strong economic growth will maintain strong loan demand.
- ❑ Rising Fed Funds rate will improve investment yields and increase yield on floating rate loans.
- ❑ Steepening curve would be best scenario for most banks. This would reduce commercial modifications. It would bring commercial pricing back to sanity.
- ❑ Rising long term rates will reduce refinancing, reducing mortgage origination.

Liability Side of Balance Sheet:

- ❑ Deposit cost remain historically low. Will pricing on deposits change if Fed funds move to 1%? 1.25%? 1.50%? When will the MMMF [Fidelity & Vanguard] become competitive?

There are pluses and minuses to rising rates.

Increasing Rates & Deposit Pricing Sensitivity

Account	Current Rate	Pct.	Fed up +100 bps	Fed up +200 bps	Comment
NOW Acct. [$99m]	0.15%	52nd	?	?	This should not be very sensitive
MMDA [$22m]	0.40%	74th	?	?	This account normally is more sensitive.
Savings [$722m]	**0.33%**	**64th**	**?**	**?**	**This is the account that matters – large & legacy**
Retail CD [$275m]	0.70%	15th	?	?	You are way below the market pricing.
Jumbo CD [$23m]	0.74%	13th	?	?	Again significantly below the national market.

Beta Coefficient [sensitivity] – OCC Study

Account	25th Percentile	Median	75th Percentile
NOW Accounts	15%	23%	35%
Savings Accounts	15%	25%	37%
MMDA	25%	40%	55%
High Yield MMDA	35%	50%	75%

Why is depositor behavior difficult to model? Because the industry has changed!

2006: Last time rates increased!

- ❑ Branch activity is declining, but remains an important channel for many customers.
- ❑ On line banking is beginning to approach a inflection point [probably 2010-2012]
- ❑ Few banks had a virtual branch

2017: Welcome to a new world!

- ❑ Digital Banking is surpassing traditional channels
- ❑ Mobile banking growth is at an inflection point
- ❑ Customers are very tech savvy [Millennials, Gen X and Baby boomers, but even senior citizens are more aware]
- ❑ Internet banks (Ally) are poised to lead competition
- ❑ Many banks have a e-branch or virtual branch

Deposit Strategies for a Rising Rate Environment

Is there any irrational pricing in your market? I am not seeing any significant aggressive pricing.

Reviewing competitors from December, 2016 data I don’t see any pricing that is out of line. But need to look at look market in Queens.

Observations from students at **New England School of Banking**: Assignment asked for their deposit pricing strategies in 2017: **General comments:**

- ❑ Most banks plan to lag the market;
- ❑ Most are considering how to avoid pool pricing changes (MMDA and Savings);
- ❑ Some are beginning to consider CD specials, but few banks are will extend duration – mainly 13 to 22 month CDs.