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*Bank Insights*

## Why Banks Need to Know About Negative Interest Rates and Deflation

*By Leonard J. DeRoma, Invictus CFO*

Talk about negative interest rates and deflation became a bit more real when the Federal Reserve introduced the concept as part of the CCAR/DFAST stress testing **exercises** for 2016. This article looks briefly at some of the implications.

The U.S. has not had any major deflation post World War II, and, when it did occur, it was short-lived, and industry or geography specific.

Short-lived deflation is not a problem. Protracted "deflationary spirals" are. The impact falls disproportionately on real assets, particularly if the asset is debt-laden and needs to be sold. The spiral occurs in a situation where homeowners seeing prices decline try to "jump ahead" of the market and sell, leading to more downward pressure on prices. Recent vintage mortgages and CRE loans made at high collateral values would be most at risk. In a deflationary spiral, buyers wait on the sidelines for prices to fall. Economic activity slows further. Industrialized societies usually cope with deflation by inflating the money supply. However, the Fed has already done that, which leads us to the concept of negative interest rates.

Negative interest rates have occurred occassionally overseas and in a few arcane sectors of the U.S. financial markets. While banks have coped with a zero interest rate policy ("ZIRP") watching loan yields decline, they were blessed with deposits that are also interest rate sensitive, which mitigated narrowing spreads. In a NIRP ("negative interest rate policy"), gross interest income declines and inelastic non-interest expenses could continue to increase, implying a reset in what are considered "good" efficiency ratios. If rates go negative, banks need to prepare.

### How to Prepare for Negative Interest Rates

Make sure you have bank rate floors built into your loans. Variable rate loans made by community banks that are priced on a spread differential from an index will most likely still yield a positive number. But what about narrow spread commercial loans that may have been originated with a minimal number of basis points above Libor? Ensure that your core processing system can handle a rate less than zero. The expectation is that low rates will encourage consumers and businesses to borrow and spend. However, if low rates are coupled with deflation, this might not happen. Anticipatory selling could cause prepayment of mortgages.

### Impact on Securities

Bank management of securities portfolios could also become a victim of the lower/negative rates. And banks have less control over securities than loans. The inclination with bankers, like most bond investors, will be to reach for yield—either lower quality credits, longer maturities, or riskier alternative investments. Although at first bank bond portfolio managers will pat themselves on the back for being smart as portfolio prices increase, the new lower credit, longer maturity securities will create other problems. Lower quality credits don't count as much for liquidity purposes. When rates do rise, bond prices will decline, causing a drag on earnings. Lower quality bonds or longer duration bonds will be more difficult to sell. Having to recognize AOCI losses or OTTI losses will be exacerbated by the general lack of bids that exist in a bond bear market now complicated by Volcker rule trading regulations. Moving bonds into the "Hold to Maturity" category virtually eliminates the possibility of selling the bond, thus sticking the bank with a potentially long-dated, low-yielding asset. Paying more attention to liquidity will be crucial in the negative environment, which leads us to deposits.

### Deposit Quality Becomes Key

While some of the larger banks have imposed a "balance sheet usage charge" (read this as negative interest rates) on large financial counterparty customers, it will be difficult to impose such a charge on consumers and small business. The public relations angle would be a debacle. Bankers are already odious to much of the population. Charging consumers to keep their money in your bank may be theoretically possible, but that's why theorists don't run banks.

Banks will need to be more discerning about the "quality" of the deposits. In the new Basel III liquidity calculations (not required for community banks, but a very good metric), deposits are grouped into categories: stable, less stable, operational, wholesale, etc. Stable deposits are the "best" from a liquidity perspective because they are the stickiest. These are deposits of your most loyal customers and probably the ones you least want to disturb. On the

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other hand, municipal deposits are generally competitive among the local banks AND they generally require high quality collateral—collateral that is no longer available to service emergency liquidity needs. Aside from the political ramifications—are these deposits worth it? Good question for bank management to ask.

How much disintermediation will occur in a negative rate environment? As rates rise, disintermediation generally occurs. But it could also happen in a negative interest rate environment. Customers might just decide to keep the money in a mattress. So look for more cash transactions and more demands for currency. There's no precedent for this.

Look for more IRA withdrawals. An aging population and zero interest rates will force more invasion of principal.

### Unintended Consequences

This is always the wild card. Let's consider a ticking time bomb: unfunded pension liabilities. Many community banks have defined benefit retirement plans, guaranteeing a fixed payout based on service and salary. The amount of money needed in the retirement trust is based on the expectation of returns from stocks and bonds. While bond yields have been low recently, the stock market has provided a reasonable return, allowing actuaries to adjust their numbers and thus masking the low returns on bonds. If bonds go lower AND we have the expectation of deflation implying contracting equity prices, it is possible for banks to get hit with a payment notice to top up their unfunded pension liability. This could be a substantial number given the unprecedented environment. Additionally, bank corporate customers that also have defined benefit plans (including municipalities) will find themselves in the same boat. Part of the underwriting process in this environment for corporate customers should include understanding their pension requirements. Chances are that hasn't been a critical line item in the loan package recently.

Whatever happens, this promises to be a very interesting next several years. ▪

### About the Expert

***Leonard J. DeRoma*** *is a co-founder and CFO of Invictus. He began his career at Citibank and has held senior positions at Lehman Brothers, Barclays Capital and Keybank. He has a B.S. in Electrical Engineering from the Massachusetts Institute of Technology and a Masters of Business Administration from the Harvard Business School.*

## Don't Be a Rubber Stamp, FDIC Tells Boards in Special Corporate Governance Report

Community bank directors should not be rubber stamps for senior management, the Federal Deposit Insurance Corp. warns banks in a special issue of ***Supervisory Insights*** focused on corporate governance.

The report, "A Community Bank Director's Guide to Corporate Governance: 21st Century Reflections on the FDIC Pocket Guide for Directors," offers fresh perspectives on the pocket guide first published in 1988. It reminds bank directors that they must instill a "strong risk management culture" at their community banks. It's their job to use "independent judgment," which sometimes means challenging senior managers.

Community banks with higher risk profiles should have stronger risk management practices and more intense board oversight. That doesn't mean they must hire outside consultants, but they are expected to understand and monitor the bank's risks.

Troubled banks that survived the crisis were more responsive to supervisory concerns than those that failed. Directors should personally review exam reports and other regulatory communication and make sure they track progress in addressing problems, the FDIC advises.

Strategic planning is key to running a bank, the report says. Banks must ensure they have an effective strategic planning process that is "more than just a piece of paper." For most banks, the process will answer these questions: "Where are we now, where do we want to be, how do we get there, and how will we know we are successful?"

Boards must consider different scenarios for the bank "and what would be necessary to operate successfully under varied economic, market, and interest rate conditions." While the FDIC doesn't require community banks to use complicated stress testing programs, it does expect community bank directors and senior management to "understand how external changes can affect their banks." Strategic planning must also address "the need to maintain adequate capital and liquidity as the operating environment evolves in potentially unpredictable ways."

The report says that "the quality of the institution's planning process is a key consideration in the appraisal of bank management, earnings, and capital." Examiners look at the entire planning process to assess whether it is sufficient, whether the right people are involved and the "reasonableness of assumptions regarding the bank's present and future financial condition, market area(s) and competitive factors." They also look at whether the plan allows the bank to change direction when conditions change. ▪

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# View from the Sidelines: A Retired Bank Exec Shares Insights about the Economy, Regulation and the Future of Community Banks

*By Vito R. Nardelli, Invictus Executive Director*

It's been almost four years since I left the day-to-day responsibilities of running a successful community bank in my home state of New Jersey. Since then I have had time to reflect, contemplate, read, discuss, interview, and at times argue with fellow bank presidents, regulators, accountants, and lawyers about the pitfalls and opportunities for community banks in today's world. I've reached a few conclusions I'd like to share.

Let's begin with the more stringent regulatory capital requirements, Federal Reserve monetary policy, and the overall economic environment currently faced by financial institutions. It is imperative for C-suite executives and their board of directors to acknowledge the dramatic and drastic impact these changes have made to community banking. Perhaps I see it more clearly, since I am no longer at the helm of a bank. But bankers cannot hide their heads in the sand. I meet bankers every month who have not fully internalized the severity and complexity of the residual impact these significant modifications have forced on our industry.

Never before have we been faced with a Fed monetary policy that has dragged on for 10 long years and three quantitative easements, only to see the Fed minimally raise rates – and then announce less than 45 days later that there likely won't be further rate action for several more quarters. (The prior hike was in June 2006.) Some may remember 10 years ago when St. Louis Fed President James Bullard warned that the Fed's policies could cause a "lost decade". The reality is that the Fed over the course of this long, painful, and at times, stagnant recovery prescribed monetary medicine to ease the pain, but it did not cure the disease. It was thought that true recovery would be too painful to endure. The question now remains: When will the economic system recover?

I didn't feel too hopeful when I read a recent piece in the *Wall Street Journal* about how major department stores will close hundreds of stores to get back to 2006 levels of sales-per-square-foot. We can't just blame the Internet. Many of these companies had already closed stores to compensate for web sales, and new stores had been built with smaller footprints. This is just evidence to me of an economy that is not thriving.

Yet banks continue to chase too few customers at dangerously low and risky rates. Since 2009 banks have been lending at rates in the range of 3.5% to 4.5%. That's eight years of extremely low rates. Still, many banks feel compelled to deliver earnings expectations of more than a decade ago, which may not be at all prudent in today's operating environment.

The regulators for their part—and to a degree in response to political pressure—seek to minimize the effects of the current economic conditions by demanding more capital. Big banks did not fare well on the last "living will" test, and community banks are stuck with a one-size-fits-all capital requirement of between 10% and 15%. So the question remains: How can banks chart a course that will maintain safety and soundness, generate returns that are rational for the environment, and potentially take advantage of a significant opportunity in the market?

Looking from the sidelines, organic growth is not the answer. But there is one glaring target that all banks must consider: mergers and acquisitions. Think about it: One in three community banks today is struggling. Healthy banks, with smart executives and boards, that use the right analytical tools for assessing the benefits of a purchase will fare much better by targeting an M&A deal than by growing organically. M&A offers the smart bankers an opportunity to gain scale, diversify product offerings, expand geographically, gain additional manpower talent and add their own talent and leadership to an institution that may be paralyzed by regulatory constraints or crushed by the high cost of regulatory compliance.

Our industry is at a crossroads. There have been almost no de novo charters in years, and most banks don't have great succession plans, either. Taking in the entire landscape of today's banking opportunities, it's obvious to me that the only way out of the economic and regulatory quagmire for most banks is through targeted acquisitions. It is cheaper, safer, more predictable and rewarding than building organically—and it solves many of the problems that are keeping most bank CEOs awake at night. ■

## About the Expert

*Vito Nardelli has served as the President and COO of OceanFirst Financial Corp. and as president of OceanFirst Bank in New Jersey. He also held senior jobs at Trust Company Bank and First Union National Bank. He served as Executive Director of the New Jersey Economic Development Authority in the 1990s, and was a Lieutenant Colonel in the United States Air Force Reserve. He received his BS and JD degrees from Fordham University and has an MBA in Executive Management from St. John's University.*

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# Read Between the Lines

Each month *Bank Insights* reviews news from regulators and others to give perspective on regulatory challenges.

## FASB Approves – and Delays– CECL Implementation

As expected, the Financial Accounting Standards Board **voted** to go ahead with changes to the accounting standards for loan loss provisioning, but delayed implementation for a year. The current expected credit loss (CECL) model will go into effect for some public companies in December 2019 and for others in 2020 and 2021. The new standards will require most banks to provide credit quality indicators by year of **origination**. Final rules are expected in June, so banks will have several years to prepare. For more on CECL, see the October issue of ***Bank Insights***.

## FDIC Makes it Easier for De Novo Banks

With hardly any new bank charters since the financial crisis, the Federal Deposit Insurance Corp. has decided to roll back its strict **oversight** of new banks. In 2009, the FDIC increased the de novo oversight period from three to seven years, mandating that new banks adhere to higher capital and other requirements. The FDIC said that extra scrutiny is no longer needed, thanks in part to the agency's "more forward-looking approach to supervision." Beyond loosening the rules, the FDIC is also planning to sponsor outreach meetings to encourage new bank charters and is developing a new handbook to explain the process to would-be bankers. The FDIC also updated its **guidance** for those seeking deposit insurance. The guidance outlines common weaknesses in unsuccessful business plans: insufficient details, overly broad strategies, unsupported assumptions, insufficient disclosures and inadequate executive strategies.

## Federal Reserve Expands Off-Site Loan Review

The Fed wants banks below $50 billion in assets to know that it is willing to conduct its loan reviews off-site, even for community banks, as long as they can send the loan files securely to the Fed. The Fed announced its interest in expanding the off-site program in a recent **letter**, noting that examiners are already attempting to do as much exam work off-site as possible "without compromising the effectiveness of the examination process." Examiners are trying to review loan policies, loan loss reserve methodologies, risk assessments and loan groupings before they even arrive at a bank. Banks that participate in the program will also have off-site review of "credit files for quality, documentation and compliance," which could include the appropriateness of individual credit ratings.

## CRE Concentration Warning Repeated

Regulators at the FDIC's recent community banking conference **emphasized** that even small banks should start using scenario analyses and stress testing if they have concentrations. "You probably want to do some 'what ifs'," said Maryann Hunter, deputy director of the Federal Reserve Board's Division of Banking Supervision and Regulation. She said banks must understand what would happen to their portfolios if values changes, and reserve adequately for potential losses. "With commercial real estate, we have seen concentrations growing again. This was clearly a source of problems back in the earlier part of the 2000s, leading into the financial crisis," Hunter said. "We are very committed to not getting behind the eight-ball on that very issue again." Regulators **announced** in December that they "will pay special attention to potential risks associated with CRE lending" in 2016, including mandating higher capital.

## OCC Encourages Banks to Innovate, Even in Strategic Planning

Innovate, but do it responsibly. That's the message from the Office of the Comptroller of the Currency in a recent **white paper** and **speech** from Comptroller Thomas J. Curry. The paper even encourages banks "to integrate responsible innovation into their strategic planning." When considering new products, partners or services, banks must also consider the risks involved, as well as the opportunities. Curry said the OCC wants to make sure that "all of the expertise and experience of the OCC are available to support federal banks as they apply new technology and consider new ways of doing business." ▪

## About Invictus

*Invictus Consulting Group's bank analytics, strategic consulting, M&A and capital adequacy planning services are used by banks, regulators, investors and D&O insurers. For past issues of Bank Insights, please go to the* ***Invictus website****.*

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