The Baker Group

Matt Harris, CFA
Senior Vice President
The Baker Group LP
mharris@gobaker.com

Under Pressure – Net Interest Margins

A long time ago there was an adage in the banking industry known as the "3-6-3 rule," meaning the banker would gather deposits at three percent, lend them out at six percent, and be sure to arrive at the golf course by 3 o'clock in the afternoon. The implication with this old adage was that net interest margin (NIM) for banks was largely set on autopilot and required little work when it came to earnings and risk management. Following the onset of the Coronavirus pandemic and subsequent collapse in interest rates, banks continue to see their core earnings (NIM) again under heavy attack. Excess liquidity, lower asset yields, and increased competition have made the fight more challenging; however, there are still things bankers can do to ensure current profitability while maintaining acceptable risk levels and allow for future growth. As we continue to engage with bankers across the country about net interest margin erosion, here are some thoughts to help maintain or increase earnings in today's challenging environment:

Revisit Your Analytical Tools

Prudent risk managers understand the limitations of models; however, they also leverage their capabilities to understand the opportunities and risks that face them given a variety of potential interest rate scenarios. Think of your asset/liability model and interest rate risk reporting as weapons to help fight this battle against earnings compression. Review your current ALM results when it comes to earnings-at-risk and economic value equity. How do these results look in today's as well as other scenarios? Recent regulatory data has pointed to the fact that many banks are highly asset sensitive, indicating improvements in net interest margin given +200 or +300 basis point interest rate scenarios; however, they continue to face earnings pressure in today's rate environment. Bankers can extend duration in the loan or bond portfolio, in many cases due to the increased liquidity and core deposit growth, while still keeping their results well within established ALM risk parameters.

Squeeze All That's Left on Cost of Funds

Across the industry, banks were able to lower the cost of funds as the Fed dropped rate three times in 2019, followed by the emergency rate cuts that happened in 2020. As bankers evaluate their current cost of funds position, the following questions come to mind: Have you lowered your NMD rates on all products or is there any further room to drop? Have you explored setting new or additional tiers for accounts, which can increase pricing flexibility? Another place to look is the CD portfolio. While certificates of deposit continue to remain a lower part of the funding mix, we still see significant interest expenses savings as those accounts continue to reprice lower. And finally, if you do have any external or wholesale borrowings, are there opportunities to refinance?

Deploy Excess Liquidity

The pandemic brought not only a drop in interest rates but also an unprecedented flood of liquidity into the banking system. While there are some concerns across the banking community of an outflow of these deposits as interest rates normalize, there is also a consensus that many of these deposits will remain on the balance sheet for years to come. Bankers need to focus time and attention on certain ratios regarding liquidity; not only understanding the level of liquidity through liquid assets ratio but also understanding the mix of liquid assets and the yield/duration components. By spending more time breaking down the liquidity position, many banks have felt more comfortable deploying assets in today's rate environment. How does your liquidity compare with prior rate cycles? What is your liquidity comprised of? What opportunities are there to invest idle funds? Using the analytical tools discussed earlier will help in formulating the right amount of dollars to deploy.

When the Going Gets Tough, the Tough Get Going

This is not the first challenging rate environment the banking industry has experienced, nor will it be the last. Bankers will

(Continued)

continue to earn spread and conduct their core business units in a variety of rate scenarios, as they have for many decades, while still earning an acceptable spread that flows into bottom-line earnings. While banks continue to focus on credit quality and efficiency (overhead) improvements, the items discussed above help lead the institution to finally stop the bleeding from declining margins while still being prepared for rising rates as they normalize. Now is not the time to be complacent. Please take the time to evaluate your asset/liability mix and position to ensure that you are maximizing your institution's net interest margin potential in this ongoing fight.

The Baker Group is one of the nation's largest independently owned securities firms specializing in investment portfolio management for community financial institutions.

Since 1979, we've helped our clients improve decision-making, manage interest rate risk, and maximize investment portfolio performance. Our proven approach of total resource integration utilizes software and products developed by Baker's Software Solutions combined with the firm's investment experience and advice. For more information, contact* ***Matt Harris at The Baker Group: 800.937.2257, www.GoBaker.com, or email: mharris@GoBaker.com.***

**The Baker Group LP is the sole authorized distributor for the products and services developed and provided by The Baker Group Software Solutions, Inc.*

Matt Harris, CFA
Senior Vice President
The Baker Group LP