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S&B ANALYSTS' CORNER

Transitions Are Hard...

2019 WAS A YEAR OF TRANSITION IN MANY RESPECTS. We saw the trade war transform the international trade deals. We saw the Fed transition from rates up to rates down. We saw the long end of the curve transition from 3%+ to sub 2%. Needless to say, 2019 was quite a pivotal year, but as it turns out it was just a prelude for what was coming in 2020.

The start of 2020 was fairly rocky with the 10-year U.S. Treasury rates down, business spending remaining low, and continued low levels of inflation during a time of historically low unemployment. This was all before the threat of COVID-19. With the impact of COVID-19 in full effect, we can anticipate a move to lower margins and a need for greater efficiency throughout then next 12-18 months. While banks have enjoyed low cost of funds (COF) for the past 5 years, 2019 pushed up the cost of funds to just under 1% from a low of 45 bps in 2016. For the past two years, the COF has risen an average of 22 bps per year while the yield on earning assets (YEA) moved up an average of 24 bps per year. This near identical move in costs and yields has caused many institutions to see their net interest margin (NIM) move very little. In fact, the average NIM has moved up just 9 bps between 2016 and 2018. However, in 2019 we saw a slight compression in NIM of 3 bps to 3.81%. This small compression will likely continue in 2020 as asset yields fall at a faster pace than cost of funds.

So how did **Sample Bank** fair? Between 2016 and 2018, the bank's NIM moved up 22 bps. This was faster than the movement of the industry. The movement in the bank's NIM was the result of its YEA moving up 41 bps, which more than offset the 16 bps increase in its COF. With net interest income representing 83.3% of the bank's total revenue, even small movements in NIM can make a significant impact on earnings. For instance, every five bps move in NIM equates to $209.2 thousand in revenue for Sample Bank, or 3.8% of earnings before taxes. In 2019, the bank saw its NIM decrease by 42 bps compared to 2018. Additionally, its 4Q 2019 NIM was 17 bps lower than its 4Q 2018 level.

With the yield curve moving down to record lows due to the impact of COVID-19, it is important to estimate the impact of this low rate environment. Every bank is equipped to know this impact through their ALM models, but not all banks, nor their boards, fully appreciate a complete analysis of the output of their models, nor does every bank run non-parallel curves scenarios. Figure 1 shows a matrix of the percentage change in the Bank's NII based on changing its 4Q YEA and COF by varying amounts. Notice that if the YEA moves down 40 bps and the COF is reduced by 20 bps, NII falls by 2.1%. While this scenario might seem drastic, it is a possibility if we continue to see the 10y UST remain at these low levels and a refinancing wave comes. So how do we fix this issue? Well, the key will be growth. In this scenario, the bank would have to grow its earning assets by $8.9 million, or 2.12%, in order to maintain its NII at the 2019 level of $13.2 million. The trick is to grow without taking on undue credit risk.

FIGURE 1

	Yield on Earning Assets				
Cost of Funds	**3.90**	**4.10**	**4.30**	**4.50**	**4.70**
0.64	1.32%	7.65%	13.97%	20.30%	26.63%
0.74	-2.12%	4.21%	10.54%	16.87%	23.20%
0.84	-5.55%	0.78%	7.11%	13.44%	19.76%
0.94	-8.98%	-2.65%	3.67%	10.00%	16.33%
1.04	-12.41%	-6.09%	0.24%	6.57%	12.90%
1.14	-15.85%	-9.52%	-3.19%	3.14%	9.47%

We know that a continual low interest rate environment is not conducive to strong performance and that fact is doubly true when the shape of the yield curve is flat to inverted. The question is, what can you do to minimize the impact and educate your team, both boards and management, of the impact of nonparallel rate movements? Contact us to **request your bank's customized Analysts' Corner** or to schedule a call to review your bank's performance and begin the education process.

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