What going over Fiscal Cliff means for banks

Special ALCO Beat: How to prepare your bank

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Experts recommend steps to make your bank’s landing as soft as possible

Politicians are saying that going over the "Fiscal Cliff" is a distinct possibility. Given what is at stake for an already fragile economy, cooler heads will surely prevail.

But, what if they don't?

What are the ramifications for the banking industry if a game of "political chicken" takes us over the edge?

The short answer: A recession would become a high probability outcome with a very real negative impact on the banking industry, especially community banks.

The complete answer is, it depends. It depends on how long the trip down the Fiscal Cliff Lane is allowed to last, and whether the trip ends with an equivalent of kicking the can down another road, or a paradigm switching of the U.S. train to a newly designed highly reliable track.

ABA paper on “Fiscal Cliff”

In a recent white paper ABA economists point out the U.S. economies underlying strengths, in the face of the muchdebated “Fiscal Cliff.”

If the latter, perhaps we will get lucky with Washington establishing the necessary clarity to incent businesses to invest, hire, and grow our way into a brighter future sooner than most anticipate.

If the former, ouch!

What is the "Fiscal Cliff"?

Establishment of the so-called "Fiscal Cliff" (or officially the "Budget Control Act of 2011") came from a "compromise" reached by Washington to avert a government shutdown as the U.S. approached its debt ceiling in the summer of 2011. This was one of the key events that prompted a downgrade of the U.S. debt rating.

In effect, the Act allowed Washington more time to find common ground on ways to bring down the deficit, but with an ultimatum: Failure to work together constructively to find solutions would result in a series of automatic policy actions that would raise taxes (expiration of Bush tax cuts) and cut government spending.

This was affectionately dubbed the "Fiscal Cliff" due to the perceived dire consequences on economic activity if both were to occur simultaneously.

The end result of "cliff jumping," according to the Congressional Budget Office, is an estimated $560 billion reduction in the deficit. CBO also estimates the tradeoff as being a recessionary 4% to 5% reduction in GDP in 2013 and a loss of roughly one million jobs. Certainly, this will not bode well for asset quality, which in turn will not encourage banks to step up their lending activity for anyone other than those of the most pristine credit.

Ratings agencies have already opined that this will hasten another downgrade in U.S. debt ratings. Could it lead to higher interest rates? Perhaps, but the downgrade would likely be a longer-term issue and not something that would affect the U.S. in the near term.

Why? Where else would the money go? Certainly not the stock market, because it would likely be in the midst of a thrashing. To Europe? To China? We doubt it.

Instead, we believe interest rates will head lower.

This will be catastrophic for bank profitability, except for those institutions that would benefit from another refi-wave.

If a recession unfolds as projected, what should a bank be prepared to do?

Banking after "the fall"

From where we stand today, the outlook for many banks in 2013 is already not rosy, with net interest margin under significant pressure from the sustained low rate environment.

If the deficit can is kicked down the road (e.g. raise the debt ceiling and push further discussion into next year) prior to going over the cliff, or shortly thereafter, then the current economic state and level of uncertainty will likely continue; ensuring that rates remain near current levels and bank margins continue to decline.

To put this into perspective, the degree of pressure we commonly see would require most banks to achieve a 5%-10% net increase in loans in 2013 in order to head off the anticipated reduction in net interest income from their current balance sheet.

With economic growth
less than 2%, this simply will not happen for the majority of them.

Now, if Washington steps off the fiscal cliff and allows the
tax hikes and spending reductions to occur, then interest rates will be
expected to remain low for a longer period of time, with margin pressures
exacerbated by market yield curves that will likely flatten further.

How much tougher would a recession make things?

Lacking any meaningful capacity to lower deposit costs or
maintain investment portfolio yields (two common margin
preservation/improvement strategies that helped in the last recession), banks
will, by necessity, place greater emphasis on growing loans to buffer margin
erosion.

How tough is that to do (prudently) in a recessionary
environment? Recent loan trends suggest the answer is "very tough."

FDIC statistics point out that gross loan balances hit their peak in the second quarter of 2008, not too long after the U.S. economy entered negative GDP territory. GDP began to improve in early 2009 and entered positive growth territory in mid-2009. Notwithstanding, from the $7.85 trillion loan peak in 2008 through the end of 2010, loan balances contracted on a lagging basis by 9.3% to $7.25 trillion.

Since then, outstanding loan footings have recovered partially, up $328 billion at the end of Q3 2012, with 77% coming from C&I demand.

While it is hard to envision a contraction in credit as severe as it was in the last recession, it is hard not to envision business credit demands tapering off (if not reversing course) if we go "off the Cliff."

If that happens, the pool of available higher quality credits (including commercial real estate) will shrink and banks will be forced to hunt more aggressively to get their share of the action.

Can loan pricing get tighter?

Given a likely diminishing demand for credit (qualified borrowers) and willingness to extend credit (lenders), commercial related loan activity will become increasingly a zero-sum game, whereby in a growing number of instances the highest quality credits will be recycled to the "highest bidder" (lowest rate).

Pragmatically, loan growth is the best chance for most community banks to achieve top- line revenue growth. The dilemma is that there is not, and will not, be enough viable incremental growth opportunities to go around. This is why loan pricing spreads will continue to contract and risk-adjusted returns for the best credits will decline further.

We have seen term pricing spreads tighten by at least 50 bp-75 bp over the last 18-24 months (100 bp in numerous cases). How much further can they tighten? We would not be surprised if supply/demand dynamics result in at least another 50 bp-75 bp.

And you can say good-bye to loan floors.

With the elevated pressures on loan pricing spreads and further reductions in term market rates, demand for fixed-rate lending will increase. We have already seen this occurring as banks attempt to mitigate pricing spread pressures by competing with fixed-rate offerings (10-15 years.) Pressure to lend long will increase greatly.

Other headwinds to be wary of

We find it difficult to envision asset quality deteriorating to the 2009-2010 levels, though loss provisions would likely increase from present levels due to environmental risks (real or perceived). Delinquencies and classified asset levels would likely increase. Thus, reduced loan loss provisions, one of the main earnings drivers of the last two years, would not only disappear, but would also likely work against banks. Many would be pressured into rebuilding reserves.

The guess here is that if one million jobs are lost as a result of the "Cliff," it will slow the new purchase mortgage markets considerably and result in elevated foreclosure pressures (and/or short sales).

With increasing margin pressures and decreasing loan growth opportunities, every day it will get tougher to head off earnings pressures.

The bright side is that 2013, unlike 2012, is NOT a leap year and thus has fewer days.

So, what to do?

In short, a fall off the "Fiscal Cliff" will make a tough year for banks even tougher. How will you deal with it? How quickly can you turn on the loan spigot to get ahead of the likely slowdown? If you are not getting sufficient loan growth opportunities, why? Is it a concern regarding credit quality or self- imposed pricing and structure constraints?

Here are strategies to consider:

1. Loan purchase: Many have been shying away from the purchase market because of the lack of comfort in taking on credit underwritten by others. Is that fear needlessly closing a door that might be part of the answer for you? All loan purchases are not created equally.

2. Rate protection: If loan rates continue to decline, at what point do you consider utilizing interest rate swaps to reduce the risk of fixed rate lending? Or implement other balance sheet strategies to reduce longer-term interest rate risk?

3. Buying bonds: If not loans for your bank, then bond purchases may be an inevitable and necessary evil in 2013 for some banks. Do you buy them sooner versus later and enjoy more carry on the replacement bonds earlier in the year? Maybe--however, undue reliance on the bond portfolio in this (or a further deteriorating) environment can be a slippery slope if one is not extremely careful and calculating.

4. Outside the box: Below the margin line, are you ready to discuss deposit fees? Where does outsourcing make economic/business sense? Are you getting the most out of your non-interest income generating activities?

5. Cut more? Overhead should already be a discussion point. Are your branches business development centers or expensive service centers? Are you prepared to examine your branch network for cost-saving opportunities? Do expenses need to be reallocated from low opportunity/profitable elements of your business to higher opportunity/more profitable segments?

Compete or retreat: You decide--but quickly

It is a bit difficult not to sound like the Grinch Who Stole Christmas when addressing the potential consequences of something as significant as the "Fiscal Cliff."

Unfortunately, the reality is that the challenges ahead are very real.

They require an honest assessment of your bank's present performance and the outlook for the future assuming that the economy and interest rate environment do not improve for an extended period of time. A "Fiscal Cliff" disaster will only amplify the need to deal with these and other business/strategic issues sooner and more swiftly.

Unfortunately, consolidation of the industry will gain momentum.

Community banks need to re-examine the appropriateness of their focus on what they want to be in the future and how they intend to get there. "Fiscal Cliff" or not, adaptation to changing times is the key to 2013 and beyond.

About the authors

Matt Pieniazek is president of Darling Consulting Group, working nationwide in the areas of asset liability management, capital management, strategic planning, and mergers and acquisitions. He is active in helping institutions manage through the rigors of the current economic and regulatory environments. Prior to his 20 years with the firm, he was an audit manager and consultant at KPMG Peat Marwick.

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After serving as an auditor in the insurance and banking industries, Jeff Reynolds joined Darling Consulting Group in 1996, where he is now a managing director. In this capacity, Reynolds' primary responsibility is advising clients on ways to enhance earnings while more effectively managing their risk positions. He regularly assists clients with strategic and capital planning projects and has also served on numerous due diligence teams for client acquisitions.