Capital Enhancement

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McQueen Financial Advisors

Our industry has experienced tremendous growth over the past few years. Deposits at banks and credit unions grew by a whopping 36% between December 2019 and December 2021. Growth was 23% in 2020 and 11% in 2021. In prior years, it has been exceedingly rare for deposits to grow by much more than 5% to 6% per year. This impressive deposit growth has presented our industry with a big challenge. Capital ratios are getting compressed nearly everywhere. The average credit union capital ratio fell from 11.4% in 2019 to 10.3% at the end of 2021. Bank ratios fell from an average of 11.3% to 9.9%. It is truly unprecedented for these ratios to fall by over 100 basis points over such a short period of time. Earnings have generally been strong, but assets have grown far faster than capital. These trends have put earnings & capital planning at the forefront for many of our clients.

Capital Planning Basics

Rapid asset growth is not the only reason for concern. In addition, there remains considerable uncertainty about the timing and severity of recession, which could result in earnings stress. Strong capital boosts the ability to handle economic stress, so a focus on capital planning is key. Capital planning should be an ongoing activity.

To demonstrate the problem, let's consider a $500 million institution with a capital ratio of 9% at the end of 2019. The example assumes 15% deposit growth in 2020 and 10% in 2021. The institution is assumed to earn 0.40% ROA for both years.

"Focus on capital planning is key"

Year-End	Assets	Capital	Ratio
2019	$500	$45.0	9.00%
2021	$625	$49.2	7.89%

This simple example demonstrates the challenge of maintaining a strong capital ratio when deposits are growing quickly. Reasonable earnings were not sufficient to counteract the impact of the large deposit influx. As a result, the capital ratio fell by over 100 basis points.

Now, let's look at a hypothetical 2-year forward scenario which includes normal growth of 5%. The goal is to get the capital ratio back to 9.00%. To do this would require a return on assets of 1.05% each year, more than double the recent trend. As we all know, it is no easy task to quickly boost this ratio.

Year-End	Assets	Capital	Ratio
2023	$697	$62.8	9.00%

Capital Enhancement Method Considerations
Capital planning often means maintaining a focus on strong earnings. This can be accomplished by adapting to changing economic conditions, market opportunities, and considering the slope and shape of the yield curve. We have included several strategies which can be considered. However, none of them are specific recommendations. There are potential benefits and challenges discussed in detail below. We encourage you to speak with your McQueen advisor to review the steps that may be most appropriate for your institution.

- **Shrink the Balance Sheet:** It is not common for us to recommend shrinking the balance sheet. Sometimes, tough times lead to tough choices. For example, a handful of our clients have taken the extraordinary step of sending a check to depositors when CDs mature, along with a letter explaining that CDs are temporarily not an option. Other examples include clients who have intentionally offered below-market rates with the goal of either limiting deposit growth or discouraging reinvestment of maturing CDs. Think of this as a reversal of what brought us to where we are today.

"Several strategies can be considered"

- **Loan Growth:** Consumer lending is on the rise now that government stimulus funds have ended. 2nd mortgage and HELOC loans are particularly strong. Homeowners with sub-4.00% mortgages are likely to remain in their homes for a long time. 15-year loans were the preferred option during the refinance boom. These loans build equity faster and borrowers will eventually tap the excess equity for a variety of reasons. Commercial lending can become stressed during a recession, so we favor SBA loans which limit future risk and are often floating rates. 'Toy' loans like motorcycles, boats, and RVs could be troublesome due to very high gas prices and economic slowdown. Many of our clients are adjusting risk-based pricing guidelines to help protect margins, in anticipation of borrower stress.

- **Out of Market Lending:** When local demand is insufficient, loan growth can be achieved through participations, loan purchases, or indirect programs. The higher yield could supplement earnings and boost capital. However, we are concerned about these strategies during periods of economic stress. Commercial participation loans may include greater risk if a single large loan goes bad. In addition, the buyer of a loan has no control over the underwriting process or ongoing loan review. Non-standard lending always involves fees and may also result in greater charge-offs compared to in-house lending. A careful review of the 'true' yield is recommended. This should be compared to risk-free alternatives. The results are sometimes surprising. Investment yields have risen sharply, so the analysis may reveal very little benefit compared to investments.

“We recognize the challenges”

- **Other Revenue Enhancements:** There are several revenue enhancements available, and we encourage discussion of each. Some examples include branch-level investment services, SBA lending, insurance sales, debit & credit cards & mortgage sales. Many of our clients have experienced sharply lower over-limit and late fee income. However, this may be changing.
- **Branch Sale-Leaseback:** This type of transaction occurs when the owner of a branch sells the property to another party and then leases it back from the purchaser. Often, the value of branches far exceeds book value. As a seller, there are two potential benefits. Some transactions may result in a substantial tax benefit and a boost to capital. In addition, the transaction would generate liquidity which could be used for investments or loan growth. Earnings from these activities would further boost capital. Sale-leaseback transactions are not common and involve accounting, legal, and regulatory considerations.
- **Merge or Sale:** We recognize the challenges faced by smaller institutions to build capital. Earnings growth can be tough due to a lack of scale, product offerings, or depth of staff. All of us at McQueen have a fondness for thriving smaller institutions and will do all we can to help you achieve your goals. As a last resort, clients sometimes reach the conclusion to sell, seek a merger partner or to merge in a smaller strategic partner.
- **Branches:** The number of financial institution branches has fallen by nearly 20,000 (16%) over the past 10 years. The pace of permanent branch closures accelerated during the pandemic, consistent with the expanded use of online resources. In addition, there has been a considerable shift to smaller branches. The branch trend is likely to continue in favor of expanded online tools.
- **Shifting Credit Quality:** To boost earnings, loans and/or investments could be shifted towards higher risk and therefore higher yield alternatives. This is not a widely recommended strategy, especially when it appears likely that the U.S. economy is heading towards a recession. The timing and severity of economic slowdown can not be predicted with any certainty.
- **Maintain Deposit Rates:** Our recommendation rarely changes. Deposit rates should be increased only in response to the need for funds. Local competitors may boost rates, leaving us wondering why and then matching the increase to remain relevant. This is often a mistake and may lead to an unnecessary upward spiral. A quick look at any call report will reveal why this is happening. If a local competitor has a significantly higher loan to deposit ratio, it should be a reason to examine how they achieved strong lending results. The focus should be on the strategic use of funds, not simply matching local deposit rates.

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"Smart investment decisions will lead to enhanced earnings"

- **Investment Portfolio:** McQueen Financial Advisors manages in excess of $14 billion in client assets. In the current interest rate and economic environment, our portfolios are well structured ladders providing a consistent level of liquidity. We anticipate higher market volatility, higher interest rates, and a flatter or inverted yield curve. We continue to recommend a structured approach with ample flexibility to take advantage of market uncertainty and volatility. We recommend avoiding bonds with negative convexity and callable bonds. Now is as good a time as ever to review your investment portfolio. If liquidity remains ample, we recommend maintaining the current investment strategy. We continue to advise to not implement a wholesale change to the balance sheet based solely on the slope and shape of the yield curve or on speculation of what might happen. It is important to continue to book assets in this higher rate environment. Smart investment decisions will lead to enhanced earnings. We encourage you to talk with us about how higher yields may impact your institution and which bond sectors represent the best value.

Action Steps

One of the keys to implementing these ideas is to determine (in advance) if a particular strategy will yield significant results or have a material impact on your risk profile. Much of what is mentioned here can be measured using McQueen's robust ALM simulation tools. Our 24/7 On Demand ALM Simulator includes post-growth income and NEVE test results across a range of interest rate scenarios. In addition, the tool includes performance and condition ratios which can be used to help determine if a growth path is appropriate.