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Low interest rates have prompted smaller banks to seek other ways to boost profitability.
Page 23

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Uncertainty muddies crystal balls, prompts creativity

With low interest rates, smaller banks find new ways to make money

By NATE DOUGHERTY

Lawrence Heilbronner admits that the crystal ball at Canandaigua National Bank & Trust Co. has been a lot murkier over the last six or seven years.

The bank has been impacted not only by the continued low interest rates but also the uncertainty of when they might rise again. Heilbronner, executive vice president, chief financial officer and cashier at Canandaigua National Bank, and others say the low rates have been particularly difficult for community banks, many of which are more reliant on interest income and are less cushioned against low rates than their larger regional and national bank counterparts.

The low rates have also made long-term strategic planning a bit more challenging, Heilbronner says.

"The uncertainty is the worst thing for planning," he says.

Interest rates have hovered around zero since the height of the financial crisis in 2008, with the Federal Reserve dropping rates in an attempt to stimulate economic growth. While many expect the rate to increase soon—and the Federal Reserve has given indications that the benchmark interest rate will rise later this year—the low rate and continued uncertainty have been challenging.

"For financial institutions, profit is not only affected by the low level of interest rates but by the steepness of the yield curve, that difference between short- and long-term rates," says Tom Rogers, chief financial officer at ESL Federal Credit Union. "As the curve gets flatter with less difference, financial institutions are finding it more difficult to make money.

"It's been challenging for us and for all financial institutions as deposits bottom out and loan rates continue to fall."

Local institutions have responded to the low rates by accelerating the growth of non-interest income, but leaders say it remains difficult to look ahead with no clear idea of when rates will increase.

Feeling pressure

The low interest rates have affected banks nationwide, but the pinch has often been felt the most at the smaller levels, Heilbronner says.

"The larger regional and super-regional banks tend to have more short-term maturities, which put them in lower interest rates to begin with so they didn't take as much of a hit," he says.

Kevin Klotzbach, chief financial officer of Five Star Bank, adds that many of the smaller and less fully equipped banks have not survived the low interest rates.

"What you see in the industry is the vast majority of community banks, ones even smaller than our own, have been challenged to grow because they don't have access to capital," Klotzbach says. "What we've seen is approximately 30 banks a month are being gobbled up by larger banks. Part of that has been from the low interest rate environment, but other regulatory costs are a factor as well."

Interest rates have influenced an institution's ability to branch out in other ways, says Clifford Smith, professor of business administration and finance and economics at the Simon Business School at the University of Rochester. For example, banks strapped by slow growth have found it more difficult to make meaningful investments in technology.

"There's an ongoing technological change in the industry, but a lot of the most efficient technology right now is still associated with big-scale economies," Smith says. "That has put more pressure on smaller banks to either grow organically or through acquisition."

But the low interest rates are not all negative, Heilbronner says.

"While this is difficult for banks, it's advantageous to customers, with new customers taking advantage of low rates and existing customers using the opportunity to refinance," he says.

Branching out

Generating revenue from fee-based services has been a priority for banks dating back before the recession, but for many community banks the low interest rates have pushed along plans to increase non-interest revenue. Many have added onto their ancillary offerings including wealth management or insurance, increasing their share of revenue not dependent on interest rates.

At ESL Federal Credit Union, the move to increase the non-interest share of total revenue has been deliberate over the course of the last 15 years or so, says Faheem Masood, president and chief operating officer. Masood says that the credit union's interest income has dropped from roughly 83 percent of all income in 2000 to about 70 percent today.

"The diversification of revenue by offering things like wealth management services and business banking has generated a lot more non-interest income, and a big source has also been on the payments side with the fees and account services related to debit and credit cards," he says.

Masood says ESL was on a course to diversify income even before the recession, but it has seized opportunities to branch out into new areas.

Other banks have branched out in recent years. In May 2014, Financial Institutions Inc., the parent company of Five Star Bank, acquired Scott Danahy Naylon Co., Inc., a full-service insurance agency based in Erie County. The acquisition was an important part of the bank's strategy to diversify revenue by adding non-interest income, noted Martin Birmingham, the bank's president and CEO at the time.

Tompkins Financial Corp. has increased its non-interest offerings, and in 2014 announced plans for a two-story building in Batavia to host a call center for its insurance and bank subsidiaries. Tompkins also is the parent company of wealth management entity Tompkins Financial Advisors.

Low interest rates are not the only factor pushing banks to add more non-interest income, Smith says. Easing regulations have also allowed them to enter new arenas.

"This is in part related to low rates, but in another sense moving to other services is a response to changes in the regulatory environment," Smith says. "It used to be that if you were a commercial bank, you couldn't also sell insurance or offer investment products. But it's been a few years now that those regulations that kept commercial banks separate from insurance companies or investment banks, and more firms are now doing this."

Looking ahead

Low interest rates have factored into long-term planning as well.

Attempts to predict when and how the interest rates might increase is also an important part of projections for Five Star Bank. Klotzbach says the bank uses modeling of different rate changes when looking forward.

"We do a lot of interest rate risk modeling to protect ourselves against changes in the rate, so no matter what the rates do we have a book of assets and liabilities that will allow us to continue to earn money," he says.

But Klotzbach says that every projection naturally works in a bit of objectivity, and that Five Star Bank tends toward a more conservative outlook. The bank uses the median projections of a group of 70 economists reporting to Bloomberg, he says.

Klotzbach says the bank is generally more guarded.

"At the moment the outlook appears to be that the Fed will raise rates one or two times, but our bias is that they'll raise once and the fed funds rate will be around 50 basis points," he says.

At ESL, the low rates have been a consideration for plans but long-term goals remained focused on profitability, Masood says.

"It's that profitability that really fuels our strategic plan," he says. "That profitability is ultimately in having a strong capital position, and keeping a strong capital division has been able to keep us from those shocks in the marketplace."

But even raising interest rates may not have the immediate impact many are expecting, Klotzbach adds.

"The natural expectation in the market is that because the Fed raises rates, the entire interest rate curve will move up," he says. "I don't think that's necessarily true. The Fed could raise rates once or twice but in fact, because the economy isn't responding quite as you'd expect it to, the long end of the curve won't necessarily move up at the same rate."

Canandaigua National Bank has tried to prepare for the rise in interest rates by buying securities with shorter maturity periods than normal, allowing the bank to re-invest when rates rise.

When that could actually happen and just how much rates could rise is still the mystery, Heilbronner says.

"We've taken the approach that we don't know when this is going to happen but we know that it will, so we want to be prepared to take advantage when those rates finally do go up," he says.

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